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THE EFFECTS OF LDC SUBSIDY PROGRAMS ON LDC INDUSTRIAL DEVELOPMENT AND TRADE

MAURICE ERNST
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WITH CONTRIBUTIONS BY
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FOREWORD

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EXECUTIVE SUMMARY

Subsidies have long been used by governments to promote economic development, stabilize incomes, and narrow the spread in income distribution. Although distinctions have been made in U.S. law and in GATT between allowable subsidies and those that constitute "unfair trade," the use of subsidies by developing countries did not become an important trade issue until the mid-1970s. Various forms of government intervention in the economy in developing countries were considered justified in order to bring infant industries to a more mature and efficient status, to take advantage of other types of externalities, and to compensate for inequities and rigidities in the socioeconomic structure. Even where these justifications were not accepted, LDC exports of most manufactures, other than traditional items like textiles and clothing, did not grow rapidly enough to constitute much of a problem in industrial country markets and therefore did not become important sources of trade disputes, until well into the 1970s.

Subsidies in Third World countries have had the following principal functions:

- To eliminate or offset the bias against exports caused by import duties and controls and by other indirect taxes that raise export costs;
- To implement industrial policy priorities by giving tax and other advantages to certain industries;
- To sustain key industries through their infant phase or in periods of global recession;
- To promote agricultural production, especially of basic foods;
- To stabilize prices and insure adequate supplies of necessities for domestic consumption;
- To discourage imports, especially in the case of energy products; and
- To expand exports in general and exports of targeted industries in particular.

No one has ever questioned the right of national governments to pursue such objectives, only the use of subsidies to pursue them. Affected industries in importing countries have often charged that subsidies place them at a competitive disadvantage. Although there has been general agreement that rebates for import duties and indirect taxes affecting exporters' costs are legitimate, there have been many cases in which these rebates were considered excessive. There have also been difficulties over income tax rebates given to exporters, since the rebates favored exports over domestic sales. More frequently, difficulties have arisen as a result of subsidy programs ostensibly aimed at domestic objectives, but which, favored exporters, at least incidentally. This has been an especially severe problem in countries where a substantial share of production in many sectors is exported.

The United States has been the prime mover in international efforts to regulate subsidies and the dominant source of bilateral pressure on LDCs to modify or eliminate their subsidy programs. The 1974 U.S. Trade Act made it easier for private parties to bring suit based on claims of unfair subsidies. As a result of the 1979 Tokyo Round GATT negotiations, many developing countries accepted a general definition of unfair subsidies and committed themselves to reducing or eliminating subsidy programs within a few years. For its part, the U.S. agreed to require an "injury" test in subsidies cases involving signatories of the GATT agreement. Pressure on LDCs to modify their subsidy policies took the form of a large number of countervailing duty (CVD) trade cases in the U.S.: 115 cases in the late 1970s; almost 300 between 1980 and 1985.

The eight developing countries covered in this study include those with the largest volume of international trade. They represent widely different levels of economic development (from very poor India, to near industrial level Singapore), and sizes (from near continental size Brazil and India to city-states like Singapore and Hong Kong). In general, the relatively small, export-oriented economies--South Korea, Taiwan, Hong Kong, and Singapore--have performed better in terms of growth rates, inflation, and income distribution than the larger, more inward-oriented economies--India, Indonesia, Brazil, and Mexico. Some of the most important similarities and differences among these countries are:

- Hong Kong and Singapore both orient their economies almost exclusively to exports, but the role of the government in these two countries has differed a great deal. Hong Kong has followed a generally laissez faire policy, limiting government's role to establishing a free and peaceful environment for private enterprise, while in Singapore the government has played a major role in guiding economic development.

- South Korea and Taiwan both shifted early from import-substitution to export-promotion policies and both maintained elaborate sets of import controls. In both countries, the government actively guided economic development. But the South Korean government directs economic activity in a more specific way than the government of Taiwan, and it pursues macroeconomic policies that entail greater risk-taking and thus result in a higher average inflation rate than in Taiwan. Occasionally, South Korea's policies also lead to an overvalued currency, and a substantial, although not especially burdensome, foreign debt.

- Brazil and Mexico have both promoted industrialization mainly through import-substitution and have relied heavily on government enterprises. Each has accepted high inflation in order to sustain economic growth (Brazil more than Mexico), which has led to frequently overvalued currencies, balance of payments crises, and massive foreign debts. The debt burden will represent the most difficult political and economic adjustment problem for both countries over the foreseeable future. Both countries have been trying to rapidly expand exports of manufactures, but Brazil has been by far the more successful, partly because it began its export drive in the 1970s. Mexico, as a major oil exporter, did not see the long-term need for export expansion until oil prices fell in the early 1980s.

- Both India and Indonesia have had very inward-looking economies. Industrialization occurred through import-substitution, leaving exporters of most goods at a severe disadvantage. Both countries, moreover, have highly controlled, inefficient domestic markets that respond slowly to new incentives. In India, an elaborate web of regulations constrains flexibility and hinders growth. Neither country has made much headway in industrial country markets with exports of nontraditional manufactures.

The use of subsidies in these eight countries is a direct reflection of their economic systems and policies. In general, the countries with more elaborate government controls and less disciplined macroeconomic policies make the greatest use of subsidies and encounter the greatest difficulties as a consequence: government controls cause price distortions that subsidies are designed to offset; poorly disciplined macroeconomic policies frequently lead to overvalued currencies, which, unless offset by subsidies, make exporting difficult.

At one end of the subsidy-imposition scale, Hong Kong's laissez faire economic policies essentially preclude the use of subsidies. The government does not try to influence the structure of the economy to any great extent and pays little attention to income distribution, except with regard to the price of housing. It does finance a good deal of export-promotion, but not to an extent that is disproportionate to the dominant role of exports in the economy.

In Singapore, the government plays a major role both in stimulating economic development along certain lines and in assuring an equitable distribution of real income among the population. Although the government does not cover the losses of unprofitable firms, it does provide strong tax incentives, including substantial income tax rebates, to firms in favored industries. These rebates have been the cause of several countervailing duty cases filed by the United States against Singaporean products.

Taiwan has used subsidies mainly to reimburse exporters for the costs of import protection, to guide economic development, and to stabilize the prices of basic foods at levels profitable to farmers. The reimbursement of tariffs and indirect taxes affecting exporters has created no major problems for Taiwan, but the subsidies designed to influence industrial development (in the form of income tax deductions, reduced tax rates, low interest loans, and other concessions) are a potential source of trade difficulties. They have been targeted to a few firms in some narrowly-defined industries and have had at least the incidental effect of improving these firms' competitive position in export markets.

South Korea has used an even wider range of subsidies than Taiwan, and its government has targeted specific firms for assistance. Because credit has been severely rationed in South Korea, at least until recently, access to bank credit itself is an important form of subsidy because alternative sources of funds are either unavailable or very expensive. The South Korean government has used its control over credit to direct industrial development and facilitate exports. In some cases, these credits have been at interest rates below the cost of funds to the government. In addition, there have been a variety of tax concessions, that became quite large in periods when the South Korean currency had become overvalued. South Korea has encountered fairly serious difficulties over subsidy policies in trade with the United States. There were 4 countervailing duty cases for South Korean products during 1975-80, and another 8 cases during 1981-86. Many of the more recent cases involved steel products and were therefore dropped after the negotiation of the Voluntary Export Restraint Agreement (VER) on steel between the U.S. and South Korea in 1985. South Korea has taken other steps to deal with U.S. objections to its subsidy programs by modifying them and committing itself to further changes in the future.

Brazil has encountered more difficulties with the United States as a result of its subsidy policies than any other developing country. These difficulties have stemmed from the large role that the Brazilian government plays in the economy, the overwhelming priority it gives to economic growth, and its willingness to allow the currency to be substantially overvalued for long periods. Partly in reaction to balance of payments difficulties caused by the two oil price shocks of the 1970s, the Brazilian government gave a high priority to the expansion of exports of manufactures while continuing to pursue import-substitution policies. The realization of these objectives required the payment of very large subsidies, often including excessive rebates of import tariffs and indirect taxes, income tax rebates, and loans at below-market rates.

The Brazilian subsidies were designed to offset the currency overvaluation. At a time when Brazilian exports of many manufactured goods were penetrating the U.S. market on a substantial scale, these practices gave rise to numerous countervailing duty suits (4 cases in 1975-80 and another 19 cases in 1981-86). Since the devaluations of the early 1980s and the debt crisis of 1983, Brazil has phased out the subsidy programs that were most clearly in violation of U.S. law and the GATT code. At the same time, the CVD cases on Brazilian steel were all dropped upon negotiation of the Voluntary Restraint Agreement between Brazil and the United States on steel in 1985. But many problems remain, and the Brazilian approach to both domestic and trade policy virtually insures a continuation of these problems in the future.

Mexico's highly elaborate system of government controls also induced widespread use of subsidies to support production and consumption. For the most part, however, Mexican exports of manufactured goods were too small to elicit much response abroad until the mid-1970s, while the U.S. government tended to give Mexico the benefit of the doubt in those few CVD cases that did occur. Mexico's refusal to join GATT in 1979 however, made it possible to bring suit against Mexican firms without proving injury. After 1982, with the collapse of oil prices and the advent of the Mexican debt crisis the government began to push exports of industrial goods to the United States as quickly as possible, triggering a sudden surge of CVD cases against Mexico. These have since been halted, however, by the Mexican agreement to join GATT, by the VER on steel, by a new Mexican program to begin to liberalize the economy, and by reductions in some subsidies. The list of Mexican subsidies that have been sources of difficulty with the United States is long. It includes: excessive reimbursement of indirect taxes; rebates of direct taxes; various financing programs involving loans at below-market interest rates; and other kinds of concessions.

India is subject to the most elaborate set of government controls of any country covered by this study. These controls, which include tight quantitative restrictions on imports, foreign exchange quotas for each major enterprise, very high tariffs, and severe restrictions on the expansion of capacity and production, make the domestic market much more profitable than the export market for a great majority of Indian firms, unless they receive large subsidies. Indeed, despite a wide variety of subsidy programs, which include rebates of both indirect and direct taxes, as well as low-cost financing, it is difficult for Indian firms to export nontraditional products at a profit. There is little doubt that Indian exports of steel, machinery, and chemicals have been subsidized through direct payments to state enterprises from the government budget. But because these exports went predominantly to Third World markets, they did not occasion trade frictions with the United States. The Indian tax rebate programs for exports that were countervailed in the United States were vulnerable, not because the rebates were necessarily excessive or inappropriate, but rather because their link with indirect taxes could not be documented. The best-organized Indian exporters subject to countervailing duty cases, the textile exporters, were able to justify these programs; other, less well-organized exporters, such as those producing manhole covers, were unable to make a clear link, and so lost their cases.

Indonesia has basically followed the same kinds of inward-looking, import substitution policies as India, with heavy government controls. But, unlike India, Indonesia has been able to import large volumes of capital goods and other products, thanks to its large earning from oil exports. Consequently, its import-substitution-oriented industrialization has been far more narrow than India's. Indonesian exports of manufactured goods have been too small to occasion much protective reaction in foreign markets, and even the recent efforts to expand these exports because of the decline in oil prices have affected mainly traditional industries, such as textiles and clothing, which are regulated more by import quotas in foreign countries than by countervailing duty cases. Indonesia does use a wide variety of subsidies, however, and, as its exports of manufacturers develop, the number of countervailing duty cases is likely to increase substantially.

In general, it is clear that the use and impact of subsidies cannot be separated from the impact of the economic and trade policies of each country. As a rule, the more inward-looking the economic policies of a given country, and the more interventionist its government, the greater the price distortions in a country's economy. The greater the price distortions, the more widespread and complex must be the use of subsidies. And the more widespread and complex is the use of subsidies, the more likely is a country to encounter difficulties over its trade policy. It is very difficult, if not impossible, to compensate exporters for all the cost disadvantages due to import protection and other government controls and still stay within GATT guidelines and U.S. law. Moreover, it is impossible to meet these U.S. and GATT criteria where subsidies are used to offset an overvalued currency.

There is little doubt that the more interventionist, inward-looking economies have done less well over the years than the more free-market, outward-looking economies. The former have generally had lower rates of economic growth, higher inflation, and in most cases, less equitable income distribution. For this basic reason, U.S. pressure on these countries to reduce the use of subsidies is probably desirable. Indeed, this pressure has probably contributed to the general, if somewhat slow, trend toward economic liberalization in the Third World. U.S. leverage, however, varies a great deal from country to country. For example, it is very strong in South Korea and Taiwan, because these countries depend heavily both on the U.S. market and on U.S. political and security support. It is substantial in Mexico, because of that country's proximity to the United States and heavy dependence on the U.S. market. But U.S. leverage is very limited in Brazil, Indonesia, and India, both because their dependence on the U.S. market is low and because the governments of these countries consider their internal economies large enough to permit them to turn inward rather than acceding to what they consider to be excessive external demands.

The findings of this study suggest that reduction of the market distortions that create the need for subsidies--due to exchange rate overvaluation, high rates of protection from imports, and widespread use of government controls--is in the best interest of the Third World countries themselves. U.S. pressure can contribute to the general process of economic liberalization, and CVD cases can be an effective means of pressure. But it is important to avoid exacerbating the already strong irritation felt by some countries with what they regard as U.S. procedures in CVD cases which impose U.S. criteria on their own economic system and contribute an excessive administrative burden.

New trade bills, introduced in Congress are almost certain to attempt further broadening of criteria for "unfair trade," especially subsidies. They are likely to further increase the amount of administrative discretion given to the Department of Commerce, as well as increase the political pressure to apply this discretion to the advantage of U.S. producers. In this way, the Department of Commerce is forced to dig even more deeply into the intricacies of the price, fiscal, and trade systems in foreign countries, and to apply criteria that, while reasonable in the U.S. context, can be very troublesome to a country whose politics and economic institutions differ greatly, and differ especially in the role that the government plays in the economy. This investigative process threatens to create political frictions and costs that outweigh the benefits gained from the penalties sometimes imposed. While there is no doubt that U.S. pressure has played an important, though not dominant role, in pushing LDCs toward more open economic systems, further growth of this process could be counterproductive, especially if the issues involved are relatively minor.

I. INTRODUCTION

Trade with developing countries has become increasingly important to the United States, both as a source of imports and as a market for exports. At the same time, developing countries have been major participants in the emergence of enormous U.S. trade deficits (Table I-1). In light of the growing pressures for protectionism in the U.S., it has become imperative to sort out the role of various factors that can contribute to the surge of LDC exports to the United States. The political challenge has intensified as various developing countries have moved from labor- and raw materials-intensive production into more capital-skill- and knowledge-intensive production, just as the now advanced countries did earlier. Many of the domestic policies used by these countries to promote economic development are perceived to have unfair impacts on their trading relationships with the United States. Such impacts can no longer be ignored, as they generally were when the global competitive challenges to U.S. producers were much smaller.

One aspect of LDC economic policies that has become particularly troublesome in recent years is the use of subsidies. There is controversy even over the appropriate definition of subsidies. While explicit trade barriers have been lowered under the various rounds of GATT agreements, a wide range of domestic policies has come to be seen as possibly conferring unfair advantage. All governments, to one degree or another, seek to encourage industrial development, to redistribute income among regions and groups of people, and to support certain economic activities (e.g. agriculture, steel, "informatics"). Frequently, such efforts are specifically intended to expand exports; however, they also have implications for trade, even when they are not trade targeted. Not surprisingly, such policies have become a source of considerable tension in both multilateral trade negotiations and bilateral trade relations with the United States. The subsidies issue is a subset of this broader debate among trading partners over differences in domestic policy.

Most of the controversy has been among the industrial countries, reflecting their dominant share of world trade. But since the late 1970s, the policies of developing countries have drawn growing attention. The number of countervailing duty (CVD) cases brought in the U.S. against developing country imports has grown dramatically. Although this reflects in large part a political response to worsening U.S. trade balances and the persistence of a much stronger U.S. dollar, it also reflects a reaction to the rapid growth of U.S. imports from countries that use targeted policies to promote economic development.

The result is political tensions between the U.S. and various developing countries. CVD proceedings in the United States are often viewed in the target country as a deliberate effort to restrain their exports outside of the multilateral agreements. In the U.S., two perceptions are prevalent: 1) many developing countries are flooding U.S. markets with products subsidized

Table I-1

U.S. BILATERAL TRADE SURPLUSES AND DEFICITS, 1983-85 BY TOP 25 COUNTRIES IN 1985
(Domestic and Foreign Exports, f.a.s.; General Imports, c.i.f.)
(Millions of US Dollars)

	Trade Surplus[1]				Trade Deficit[2]		
	1983	1984	1985		1983	1984	1985
Netherlands	4,619	3,225	2,901	Japan	21,665	36,796	49,749
Saudi Arabia	4,063	1,556	2,447	Canada	14,302	20,387	22,176
Australia	1,532	1,894	2,372	Taiwan	7,443	11,085	13,061
Egypt	2,488	2,522	2,239	Germany, West	4,492	8,726	12,182
USSR	1,628	2,684	1,980	Hong Kong	4,261	5,836	6,208
Belgium/Luxembough	2,539	2,014	1,351	Mexico	7,937	6,275	5,757
Pakistan	629	825	743	Italy	1,912	4,129	5,756
Turkey	447	785	649	Brazil	2,824	5,633	5,007
Ireland	533	480	400	Korea, South	1,732	4,045	4,756
Israel	717	385	379	United Kingdom	2,279	2,835	4,300
Jordan	431	294	363	Indonesia	4,191	4,651	4,138
Kuwait	602	355	353	France	346	2,480	3,864
Libya	190	190	264	Venezuela	2,361	3,443	3,431
Bermuda	174	217	251	Nigeria	3,019	2,029	2,432
Tunisia	182	402	243	Sweden	967	1,884	2,414
Morocco	405	487	235	Algeria	3,221	3,250	1,996
Sudan	136	114	234	Ecuador	922	1,149	1,385
Panama	370	392	208	Switzerland	-409	637	1,291
Ethiopia	-51	85	157	Denmark	477	913	1,091
Bahamas	-1,294	-663	134	South Africa	-31	312	975
Lebanon	467	278	121	Angola	857	950	957
Jamaica	145	80	112	Philippines	352	856	955
Oman	-199	-2	110	Singapore	-790	446	937
Syria	103	102	103	Malaysia	521	969	860

Notes: 1) Negative sign indicates a trade deficit. 2) Negative sign indicates a trade surplus.

Source: U.S. Department of Commerce, International Trade Administration, United States Trade: Performance in 1985 and Outlook (October 1986), p. 118.

in ways not adequately covered by current legislation, and 2) greater use of CVD and anti-dumping cases are the only mechanisms available to slow the flood of imports while more direct legislative or negotiated solutions are sought. From this perspective, the large number of negative findings only raises the level of frustration with the safeguards negotiated under multilateral auspices: they are too little, too late.

In the light of growing trade-related political tensions, it is important to look at LDC programs that might constitute subsidies from several different perspectives. What programs exist, and what are their goals? How do they fit into overall economic development strategies? Do such programs in fact address their intended goals? What are their indirect effects?

The purpose of this study is to evaluate the subsidy programs of selected LDCs and their effects on resource allocation and trade flows. It compares a group of high growth, high export LDCs--Singapore, Hong Kong, Taiwan, and South Korea--and a group of more inwardly oriented, generally slower-growth LDCs--Brazil, Mexico, Indonesia, and India--to determine what use has been made of subsidies in guiding their industrial development and exports. It is designed to assist in preparing future trade negotiations and to provide perspectives for possible changes in U.S. trade legislation.

The analysis proceeds as follows: after this historical, contextual overview, Chapter II provides a brief description of the definitions and classifications used in the treatment of subsidies in this study, a brief review of the general considerations affecting the role of subsidies as an international trade issue, and a brief history of the legal treatment of subsidies in multilateral and U.S. trade legislation. The last part of Chapter II provides a general comparison of the eight countries examined in this study as an introduction to the individual country chapters. Chapters III through X assess each country's use of subsidies. Finally, Chapter XI draws conclusions and suggests policy implications.

II. CONCEPTS AND HISTORICAL DEVELOPMENT

A. Definition and Types of Subsidies

It is difficult to establish a single set of definitions, classifications, and criteria for subsidies. Different approaches would be appropriate for an economics seminar, a legal brief, a U.S. policy concept paper for GATT negotiations, a LDC negotiation paper, or a study of subsidies as instruments of socio-economic development.

Since this study examines the use of subsidies in LDCs from a variety of perspectives, it does not adopt a normative definition or approach. Instead, it takes a pragmatic approach that permits coverage of a wide variety of subsidies (whether or not they are considered countervailable), and concentrates on those which have been, or could become, sources of international trade disputes.

Consequently, a wide range of government interventions for both export and domestic purposes are treated as subsidies, including various types of financial benefits and concessions by the government to producers and consumers (direct budgetary payments, tax rebates, preferential financing, and preferential import pricing). The market value of a government concession on regulations, such as easier access to import licenses, is also considered a subsidy.

Although the role of subsidies in each country's economic development is assessed in terms of both government objectives and impact, special attention is given to export subsidies and domestic subsidies that affect exports because these are generally the source of trade frictions.

Although subsidies are the subject of policy debates among governments, international trade organizations, and academics, there is no conclusive, comprehensive and widely accepted definition of a subsidy. Because subsidies can have many different forms and are consequently difficult to identify and analyze, few existing definitions of subsidies can be consistently interpreted and applied.

In our literature review of subsidies, we found that subsidies are broadly defined as instruments (measures, incentives, and government aids) used by governments to direct resources into priority areas and to compensate for disadvantages or distortions in the economy. These government aids are sometimes general--that is, available to all industries--and sometimes specific to a particular firm, industry, region or activity.

Subsidies may be used to mitigate what a government believes to be inequitable or inefficient consequences of the operation of the economic system--for example, income distribution inequities or imperfect capital markets. Subsidies can also be used to compensate for the distortive effects of other policies, such as overvalued exchange rates, or protectionist devices like tariffs and import restrictions.

A central issue in judging a subsidy is whether or not it has a "net incentive effect"--that is, whether it overcompensates for some identifiable policy-induced disincentives and consequently is a positive inducement affecting the allocation of resources. In practice, it is usually difficult to determine whether, and to what extent, an incentive measure has a "net incentive effect" because of data limitations and conceptual ambiguities. Consequently, we have treated subsidies in "gross" terms rather than in "net" terms--that is, we have included them in our data and discussion whether or not they were found to have had a "net incentive effect" in particular cases.

Subsidies can be categorized in several useful ways: by objective (economic growth, social welfare, national security); by function (to promote production, consumption or exports); or by type (such as fiscal and financial incentives).

Because of the dissimilarities in political systems and institutional structures in the selected developing countries, the objectives of subsidy programs are discussed in the text, but they are not a systematic part of our classification. We have tried to classify subsidies by function, separating export subsidies from domestic (production or consumption) subsidies. This distinction is sometimes arbitrary, but it serves to focus on the subsidies that are most often sources of trade disputes.

Export and domestic subsidies are classified by type--those that constitute fiscal and financial incentives. Under fiscal incentives are export taxes, income tax concessions, border tax adjustment, import duty concessions on imports of inputs and equipment used for the manufacture of exports, and accelerated depreciation. Also included are subsidized infrastructure construction, provision of free or below cost marketing and investment services, and industrial estates.

Under financial incentives are low-interest rate loans, direct cash assistance, preferential access to credit at established rates, and preferential access to foreign exchange.

B. Subsidies As International Trade Issues

1. Basic Issues

There has been general agreement internationally that certain subsidies are justified in certain situations. It is generally agreed, for example, that governments have the right to tax or subsidize activities in order to achieve general social, political, or economic objectives. One of the principal economic justifications for subsidies is that they may facilitate the development of external economies in an industry--for example, by decreasing costs as the scale of output rises. This rationale is often used by developing countries also to justify the imposition of protective import barriers as they seek to develop infant industries. Finally, there is general agreement that indirect, but not direct taxes, can be rebated to enterprises because they are assumed to be passed on to the final consumer; imposing them on exports would, therefore, put an exporter paying high indirect taxes at a disadvantage.

There are serious conceptual difficulties with these criteria. For example, direct taxes are also passed on to consumers, at least in the longer-term, as are indirect taxes. Moreover, the rebating of indirect taxes on exports, while imposing them on imports, will aid exporters whose products are subject to these taxes, but will harm other exporters who would have benefited from the lower exchange rates that should have occurred in the absence of the tax rebates.

The many theoretical uncertainties and practical ambiguities in the application of these generally accepted principles have led to the development of more concrete guidelines for determining which subsidies should be allowed and which should not. There have been differences in emphasis between those who stress the distorting effect of subsidies on prices and earnings in the exporting country and those whose primary concern is with the extent of injury to the importing country. The first group opposes subsidies because they distort world trade and the rational allocation of resources. The second group is less ready to intervene in the internal economic systems of foreign countries; it prefers to concentrate on the impact on industries in the importing country. In practice, both criteria are taken into account, but to varying degrees.

Political factors have also led to some important distinctions in the application of subsidy criteria. Guidelines and restrictions have been applied to subsidies on manufactured goods, but rarely to those on primary products such as minerals and agricultural products. This reflects the fact that international agreements under GATT have been limited to manufactured goods. Distinctions have also been made between industrial countries and LDCs. During the 1960s and the early 1970s, little attention was paid to LDC subsidies because LDC exports of manufactured goods were small. In effect, they were allowed largely to ignore GATT agreements. But the situation changed substantially in the late 1970s and in the 1980s, as pressure on the LDCs to conform to GATT guidelines increased greatly.

In the U.S. the policy community has tended to develop a working criteria for subsidies that turns on the question of degree and is focused on their impact on international trade. The basic criteria identified by Hufbauer and Erb are that:

> ...producers in each nation should have access to internationally traded inputs at 'world' prices for use in export production and should be able to sell their own output on world markets at 'world' prices....governments should not subsidize exports, in the sense of offering incentives that encourage the sales of goods abroad at cheaper prices than their sales at home. Neither should governments operate preferential schemes for exempting wages, profits, and other types of income earned

> in the production of exported goods from direct taxation. Nor should government introduce second-best schemes to compensate particular export sectors from the adverse impact of overvalued exchange rates, the distortions created by excessive protection for domestic industry, or labor market distortions.
>
> ...governments should be free to offer general incentives to industry or agriculture--for example by way of tax relief, roads, ports, or schools--but governments should not offer sector-specific incentives that injuriously affect the commerce of another nation.
>
> ...a nation should be able to take offsetting remedial action in cases where foreign governments violate the second or third principles and the resulting trade harms the nation's economic interests.[*]

2. History of U.S. and International Treatment of Subsidies

The history of the treatment of subsidies as a subject in international trade is largely a study in the evolution of United States law and GATT agreements.[**] The U.S. is the country that has evolved the most elaborate and explicit legislation and regulations concerning subsidies and has been the prime mover in GATT negotiations on this issue. Of necessity, subsidies laws and agreements must be viewed as means of regulating conflicts among affected parties, by giving those who believe they have suffered damage an orderly means of recourse. The conceptual basis for subsidies laws is clearly less important than their practicality.

A variety of bilateral commercial treaties among European countries during the latter half of the nineteenth century included agreements designed to eliminate the use of export bounties. Most of these dealt with the refund or "drawback" of excise or import duties on export products. However, such pledges appear to have been generally ineffectual. The U.S. was apparently the first country to enact a legal provision to impose countervailing duties on imports of products that benefited from direct or indirect export bounties (the United States Tariff Act of 1890); the provision, however, targeted only sugar imports. The U.S. Tariff Act of 1897 broadened the applicability to all dutiable imports, although the method of determination was left to the discretion of the Secretary of the Treasury. The law remained unchanged until the Tariff Act of 1922, which further extended coverage to cover both official and unofficial bounties on the manufacture or production of imported dutiable goods.

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[*] Gary Claude Hufbauer and Joanna Shelton Erb, Subsidies and International Trade (Washington, D.C.: Institute for International Economics distributed by MIT Press, 1984), pp. 10-11.

[**] This brief historical discussion draws heavily on Hufbauer and Erb, op. cit., Harold B. Malmgren, International Order for Public Subsidies, Thames Essay No. 11 (London: Trade Policy Research Centre, 1977), and Belayneh Seyoum, "Export Subsidies under the MTN: An Analysis with Particular Emphasis on Developing Countries," Journal of World Trade Law, (December 1984), pp. 512-541.

From the early 1960s until the early 1970s, U.S. law dealing with subsidies remained unchanged, despite a widespread feeling that it needed revision. Since subsidy legislation was very simple and had no implementing or interpretive language, the U.S. Department of Treasury based its actions on case histories; over time, the various cases developed a series of definitions of what was meant by bounty or grant and how to determine the U.S. response.

Periodic multilateral discussions of the subsidy issue have occurred under the auspices of the General Agreement on Tariffs and Trade (GATT) since it came into force in 1947. In particular, during the period 1955 through 1962, discussions within the GATT refined lists of types of measures that were and were not to be regarded as subsidies, although no standard definition of what constitutes a subsidy was formally accepted. Late in the 1950s, the Organization for European Economic Cooperation (OEEC), the predecessor of the OECD, made a major effort to define legitimate and illegitimate subsidies.

In Western Europe, the subsidies issue was bound up with the broader debate about trade within the European Free Trade Association (EFTA) and the European Community (EC). In general, the subsidies issue has been dealt with by Western European nations mainly under the guise of policy harmonization of aid to industry and competition policy. By and large, the Western European countries and Japan chose to deal with perceived subsidies by administrative discretion rather than by legally imposed countervailing duties.

U.S. trade law towards subsidies was modified substantially by the Trade Act of 1974. For the first time, U.S. law introduced an injury test for nondutiable items and permitted some discretion to waive countervailing duties if their imposition "would be likely to seriously jeopardize the satisfactory completion of the multilateral trade negotiations." Before the 1974 Act, if a subsidy was identified, the use of countervailing duties was mandatory and did not require an injury test. U.S. trade partners were unhappy with this modification, since it only partially moved U.S. law toward the GATT standards, which require an injury test for all products, not just zero duty items. On the other hand, the U.S. Congress seemed to believe that the international rules on the use of subsidies were too weak; it was unwilling to weaken U.S. law unless new multilateral rules were also negotiated. Other important changes in the 1974 Act permitted private petitioners to mount court challenges to U.S. Treasury actions or inactions and imposed time limits upon the decisionmaking process in countervailing duty cases. These two changes led to a sharp increase in the number of countervailing duty cases in the United States.

Some argue that the U.S. 1974 Trade Act was the main impetus behind the negotiations that resulted in the 1979 GATT code on subsidies and countervailing duties. The basic result of the subsidies code negotiated in the 1979 Tokyo Round of the multilateral trade negotiations was essentially a trade-off between the U.S. and the EC. The U.S. gave up its grandfathered rights and introduced a material "injury test" requirement for code signatories before countervailing duties could be applied. The other signatories (with the EC in the lead) agreed to stricter interpretation and application of subsidies implied by Articles VI, XVI, and XXIII of the GATT, which more specifically defined the obligations relating to subsidies than had previously been the case. The subsidies code, however, did not define subsidies, but focused explicitly on their trade effects. The code included a flat prohibition of export subsidies on non-primary products and incorporated a detailed illustrative list of export subsidies.* It remained ambiguous, however, with regard to domestic subsidies. It clearly recognized that "subsidies other than export subsidies...may cause or threaten to cause injury to a domestic industry of another signatory or serious prejudice to the interest of another signatory or may nullify or impair benefits accruing to another signatory...".** However, despite this recognition, the code does not provide an illustrative list of potentially countervailable domestic subsidies; it goes on to state explicitly that "subsidies other than export subsidies are widely used as important instruments for the promotion of social and economic policy objectives and do not intend to restrict the right of signatories to use such subsidies to achieve these and other important policy objectives which they consider desirable."*** Therefore, at least by some interpretations, "...it is questionable whether the code authorizes the countervailing duties against domestic subsidies that are not granted regionally or by sector. Consequently, it is also unclear whether signatories must include such "specificity tests" into their implementing legislation."****

The U.S. Trade Agreements Act of 1979 was the implementing legislation for the new GATT agreements, including the subsidy code, although some relevant parts of the Act went further and provided more detail and stricter enforcement than the code. The main difference between the U.S. implementation in the 1979 Act and the practices of its major trading partners was that the U.S. continued to distinguish between signatories and non-signatories of the subsidies code. For non-signatories of the GATT agreement, the older U.S. legislation (Section 303 of the Tariff Act of 1930) authorizes countervailing duties to offset any bounty or grant on items exported to the United States without an injury test, except on duty-free merchandise. For countries which are signatories of the subsidies code, U.S. law requires a finding of material injury or of a threat of material injury before the countervailing duty can be assessed, and that duty shall be equivalent to the amount of the net subsidy. The 1979 Trade Agreements Act also provide much more explicit guidance than earlier U.S. law in defining an actionable subsidy. It explicitly refers to the illustrative list of export subsidies in the subsidies code and goes on to define domestic subsidies considered potentially actionable, using a series of examples.*

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*See Annex A.

**As quoted in Hans-Michael Giesen, "Upstream Subsidies: Policy and Enforcement Questions after the Trade and Tariff Act of 1984," Law and Policy in International Business, Vol. 17 (1985), pp. 248.

***Ibid., pp. 248-249.

****Giesen, op. cit., p. 249.

An important aspect of the domestic subsidies definition was the "specificity test." Only if the assistance program is targeted on specific industries or enterprises does it qualify as an actionable subsidy. The incorporation of domestic subsidies and the "specificity test" into U.S. law opened the door to a variety of test cases and the exploration of potential subsidies provided through upstream products (i.e., does a subsidy to an input to a product that is exported to the United States fall within the general guidelines of an actionable subsidy under U.S. law?). These cases ultimately led to some specific modifications of the subsidies language in the U.S. Trade and Tariff Act of 1984.**

The Tokyo Round of GATT talks did not achieve all of the objectives of the United States. Although the GATT criteria that emerged from the Tokyo Round were close to those in the 1979 U.S. Trade Bill, the commitments of major LDCs to apply these criteria were far more qualified than had been hoped. India's commitment in particular was extremely weak, and this in turn affected the commitments of other LDCs (notably Brazil), which had been prepared to be more forthcoming. Mexico, for domestic political reasons, refused to join GATT, consequently exposing itself to a much wider range of countervailing duty suits than would otherwise have been the case.

Since the Tokyo Round, the number of countervailing duty suits in the United States has increased enormously. This growth affected both LDCs and industrial countries. The surge was due less to an explicit broadening of the criteria for defining countervailable subsidies than to changes in U.S. law and administrative procedures that made it easier for private firms to engage in litigation over these matters. As a practical matter, the U.S. Department of Commerce began to investigate a much larger number and range of alleged subsidies in a larger number of cases and for more countries. The process was given a further impetus by the 1984 Trade Act and developed its own momentum as more and more firms tested the system and found that it could be used to provide at least partial relief from competitive pressures. This was in sharp contrast to the situation in the 1970s and earlier, when few such cases went anywhere; consequently, few American firms bothered to initiate such action.

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*See Annex B.

**An upstream subsidy is defined as a subsidy on an input product that has a significant effect on the cost of manufacturing the exported final merchandise. Basically it is determined by comparing the price actually paid for the subsidized product with the price the purchaser would have had to pay in an arm's length transaction.

The surge in countervailing duty cases did in fact result in the imposition of a fairly large number of countervailing duties, either in the form of a compensatory export tax in the developing country or countervailing tariffs in the U.S. The number of cases and their outcome are presented in Table II-1. In 1985, however, the number of outstanding countervailing duty cases in the United States declined significantly, partly because of Mexico's agreement to join GATT and partly because of the negotiation of voluntary export restraint agreements (VERs) on steel with Brazil, Mexico, South Korea, and Taiwan, which superseded ongoing countervailing duty cases on steel and steel products.

New trade bills, introduced in Congress during the 1986-87 session and modified during the 1987-88 session, have attempted to further broaden the criteria for "unfair trade," especially subsidies. They are likely to further increase the administrative discretion given to the Department of Commerce, as well as increase the political pressure to apply this discretion to the advantage of U.S. producers. In this way, the Department of Commerce is forced to dig ever more deeply into the intricacies of the price, fiscal, and trade systems in foreign countries, and to apply criteria that, while reasonable in the U.S. context, can be very troublesome to a country whose politics and economic institutions differ greatly, and differ especially in terms of the role that the government plays in the economy. This investigative process threatens to create political frictions and costs that outweigh the benefits gained from the penalties that may be imposed. On the other hand, there is no doubt that U.S. pressure has played an important, though not dominant role, in pushing LDCs toward more open economic systems.

C. Characteristics of the Selected LDCs

The eight LDCs selected for the study differ widely in their economic size, level of development, economic performance, dependence on foreign trade, and economic policy thrust and priorities, as shown in Tables II-2, II-3, and II-4.

- Two of the countries, Brazil and Mexico, are large industrializing LDCs, with per capita GNPs close to $2,000, generally rapid economic growth rates (until recent years), and a relatively low dependence on foreign trade, with exports constituting about one-sixth of GNP. Brazil's economy is of near-continental size and is well-developed and diversified. Exports, although relatively small, cover a wide range of manufactured and primary products. Mexico, however, is heavily dependent on oil exports.

- India and Indonesia also have large but undeveloped economies, with per capita incomes around $500 for Indonesia and $260 for India, and low shares of manufacturing in GNP. Indonesia's foreign trade is substantially larger than India's relative to its GNP, because of large earnings from oil exports, but the Indian economy, as well as India's exports, are far more diversified.

Table II-1

U.S. COUNTERVAILING CASES, 1973-1986

Date	Total Number of Cases Initiated	Total Number of Cases Revoked, Terminated, or Suspended	Number of Affirmative Preliminary Determinations	Number of Affirmative Final Determinations	LDC Share of Cases Initiated (Percent)	LDC Share of Final Affirmative Actions (Percent)
1973	1	1		1	---	---
1974	3			3	33.3	33.3
1975	39	35	19	16	25.6	25.0
1976	15	13	9	10	53.3	50.0
1977	15	12	13	12	46.7	50.0
1978	25	18	19	15	68.0	60.0
1979	17	16	10	8	23.5	37.5
1980	8	4	6	5	62.5	100.0
1981	18	14	5	4	11.1	25.0
1982	121	96	40	35	29.8	65.7
1983	28	20	15	15	75.0	80.0
1984	45	20	30	28	62.2	75.0
1985	43	27	18	16	51.2	37.5
1986	27	0	15	3	55.6	100.0

Source: Office of the U.S. Trade Representative, Trade Action Monitoring System, 1986.

Table II-2

GENERAL ECONOMIC CHARACTERISTICS OF EIGHT LDCs

	Population (Millions)[1]	GDP (Billion$)[1]	Per Capita GDP[1] ($)	GDP Growth[2] (%)	Share of Manufacturing in in GDP (%)[1]	Share of Exports in GDP (%)[1]	Inflation Rate (Percent) 1965-73	1973-84
Brazil	132.6	$187	$1,720	6.7	27	14	23.2	71.4
Hong Kong	5.4	31	6,330	8.6	NA	107	6.4	9.8
India	749.2	162	260	4.0	15	6	6.3	7.8
Indonesia	158.4	81	540	7.3	NA	23	63.0	17.4
Mexico	76.8	171	2,040	6.3	24	18	4.8	31.5
Singapore	2.5	18	7,260	10.2	25	176[3]	3.1	4.4
South Korea	40.1	83	2,110	8.4	28	37	15.5	17.6
Taiwan	1.9	56	3,017	9.0	36	53.2	2.9	9.0

Notes: 1) 1984; 2) 1965-84 average annual growth rate, constant prices; 3) 1983.

Sources: World Bank, World Development Report, 1986; and Council for Economic Planning and Development, Taiwan Statistical Data Book, 1986.

Table II-3

STRUCTURE OF MERCHANDISE EXPORTS
(Percentage of Total Exports in 1983)

	Fuels, Minerals & Metals	Other Primary Commodities	Textiles and Clothing	Other Manufacturing
Brazil	15	44	3	37
Hong Kong	2	6	33	36
India	18	29	14	31
Indonesia	80	12	1	7
Mexico	64	9	1	26
Singapore	31	13	4	22
South Korea	3	6	25	66
Taiwan	7	2	34	30

Source: World Bank, World Development Report, 1986; Council for Economic Planning and Development, Taiwan Statistical Data Book, 1986.

Table II-4

FOREIGN DEBT AND DEBT BURDEN, 1984

	Gross External Debt (Bil. $)	Debt/GNP Ratio (Percent)	Debt/Export Ratio (Percent)	Interest/ Export Ratio (Percent)
Brazil	102	49	336	38
Hong Kong	10	33	30	3
India	32	16	191	7
Indonesia	31	39	137	9
Mexico	97	55	298	37
Singapore	2	11	6	6
South Korea	45	56	132	12
Taiwan	9	15	24	3

Sources: Morgan Guaranty Trust Company, International Economics Department, Morgan International Data, August 1985.

- South Korea and Taiwan are both newly industrializing countries of medium size and with per capita incomes in excess of $2,000. Both economies have grown very rapidly (8 to 9 percent a year), have become highly industrialized, and depend heavily on foreign trade, especially Taiwan. Both countries almost exclusively export manufactured goods.

- The city-states of Hong Kong and Singapore have nearly achieved per capita income levels of industrial countries (about $7,000), have grown at high rates, and are heavily industrialized. Nearly all economic activity in both countries consists of adding value to imported goods for export.

The eight countries have pursued very different economic and foreign trade policies, and these differences only partly reflect basic differences in economic characteristics:

- Brazil has followed generally inward-looking economic policies and has focused on import-substitution behind high protective walls. It has over the years also given a high priority to economic growth and a lower priority to financial and price stability. As a result, Brazil has tried to sustain an overvalued currency for fairly long periods and has incurred a large foreign debt. In recent years, interest obligations on foreign debt have amounted to nearly 40 percent of export earnings.

- Mexico, like Brazil, too has stressed growth through import-substitution, but, unlike Brazil, has followed conservative financial policies and kept inflation under control until the 1970s. In the 1970s and 1980s, however, Mexico turned to highly inflationary policies, and, despite the oil boom, accumulated foreign debt and interest obligations nearly as large as Brazil's.

- South Korea has been very growth-oriented, but for more than 20 years, its growth has been largely driven by exports rather than by import substitution. Inflation has been moderately rapid but under control, although the government at times has followed risky policies, such as sustaining rapid growth through large-scale foreign borrowing during global recessions. Its policies have resulted in a large foreign debt, without causing any serious debt servicing difficulties.

- Like South Korea, Taiwan has stressed rapid economic growth through export expansion, but, unlike South Korea, has kept inflation low and avoided any substantial foreign debt accumulation. Although Taiwan has had a slightly lower growth rate than South Korea, its growth has been more stable. Taiwan is in a far stronger financial position than South Korea, with massive foreign exchange reserves and an insignificant debt service ratio.

- India, with one of the least foreign trade-dependent economies in the world, has almost exclusively stressed import-substitution and domestic socioeconomic goals. Economic growth is only one of several such goals: it has often been subordinated to such goals as sustaining employment in handicraft industries, and other social welfare objectives. India has consistently followed conservative monetary and fiscal policies, and consequently has had relatively little inflation and a small foreign debt.

- Like India, Indonesia emphasizes a variety of objectives in its economic policy, of which growth is not always the most important. But unlike India, Indonesia has had massive earnings from oil exports that permitted economic development spending on a large-scale, which inevitably caused inflationary pressures as well. To sustain this spending in the face of falling oil prices in recent years, Indonesia incurred a substantial, but not yet very burdensome, foreign debt.

- Singapore and Hong Kong have had little choice but to focus their policies on creating an economic and political environment favorable to exports. In both countries, this has meant maintaining a very stable financial and commercial environment. But their policies have differed in that the Hong Kong government has followed *laissez faire* policies and not tried to guide economic development, while the government of Singapore has systematically guided the economy toward the production of more sophisticated products, not only through labor training, but also through tax incentives and infrastructure development.

III. BRAZIL[*]

A. Characteristics of Brazil's Economic Policy

The primary objective of Brazil's economic policy has long been to promote economic growth in general and industrialization in particular. Other objectives, such as achieving more equitable income distribution, avoiding inflation, and reducing regional disparities, have not been ignored, but they have been subordinate to the goal of economic growth. Because Brazil's large size and vast natural resources provide the possibility of producing an extremely wide range of products at reasonable cost, the Brazilians have followed a growth strategy aimed predominantly at the domestic market. An important part of the strategy was to gradually substitute domestic production for imports and to promote exports, using various protective barriers. The net effect of all the taxes and subsidies affecting foreign trade was to create a bias against most exports; consequently, Brazilian producers are generally interested in exporting only when the domestic market is weak.

The relative importance of Brazil's import substitution versus export-promotion has varied greatly over time (Table III-1). During most of the 1960s, Brazil gave heavy protection to consumer goods industries and generally maintained an overvalued currency. As a result, domestic production of industrial consumer goods increased rapidly, but exports stagnated. Having largely exhausted the near-term opportunities for easy import substitution, and faced with balance of payments pressures, Brazil shifted to a more export-oriented policy in the late 1960s, relying especially on currency depreciation, various export promotion schemes, and liberalization of imports. Indeed, exports responded dramatically to these incentives, and increased much more rapidly than domestic production during the late 1960s through the mid-1970s.

Brazil could not sustain these rapid rates of economic growth during the mid- and late-1970s, however. There was a worsening of the terms of foreign trade, especially due to the large increase in the price of imported oil, and the balance of payments deteriorated. At the same time, the cruzeiro was allowed to appreciate, slowly at first, and then rapidly toward the end of the decade. As the growth of Brazilian exports slowed, the emphasis turned again to import-substitution, this time in basic industries such as steel, machinery, and equipment (Table III-2, III-3, and III-4).

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[*] The principal sources used in the preparation of this chapter are: J.W. Wheeler and Perry L. Wood, Trade Policy Formulation in Selected Developing Countries (Indianapolis, IN: Hudson Institute, April 1986); Perry Wood, Brazilian Trade Policy: The Dominance of the Domestic Market, HI-374-P (Indianapolis, IN: Hudson Institute, January 1987); Estudios e Informes de la Cepal, Trade Relations Between Brazil and the United States (Santiago, Chile: United Nations, 1985); and United States International Trade Commission, Foreign Industrial Targeting and Its Effects on U.S. Industries, Phase III, USITC Publication Number 1632 (Washington, D.C.: United States Industrial Trade Commission, January 1985).

Table III-1

AN OUTLINE OF BRAZILIAN POSTWAR INDUSTRIALIZATION

1945-1964:	Import-Substituting Industrialization
1964-1973:	Redirection/Liberalization
1964-67:	Stabilization Program
1967-73:	"Economic Miracle"
1974-1979:	Return to Import-Substitution
1979-1982:	"Stop and Go" Approach
1983-Date:	Stabilization Program IMF Extended Fund Agreement Cruzado Plan

Source: United States International Trade Commission, Foreign Industrial Targeting and Its Effects on U.S. Industries, Phase III, USITC Publication No. 1632 (Washington, D.C.: U.S. International Trade Commission, January 1985).

Table III-2

BRAZIL:
MANUFACTURED IMPORT RATIOS IN TOTAL SUPPLY
(Percentages)

	1949	1964	1967	1970	1974	1979
Non-Metallic Minerals	1.8	1.8	1.8	2.7	4.1	2.4
Metallurgy	23.6	7.5	11.5	10.0	14.7	4.6
Machinery	65.7	30.9	29.6	28.4	32.1	19.5
Electrical Equipment	47.0	7.8	11.3	18.8	20.2	14.1
Transportation Equipment	51.7	4.8	8.9	7.8	8.8	3.6
Lumber and Wood	1.5	0.1	0.2	0.4	0.7	1.0
Furniture	0.0	0.1	0.0	0.1	0.2	0.1
Paper	9.6	5.8	6.8	8.6	11.5	4.9
Rubber	3.0	0.3	0.7	2.9	8.3	4.4
Leather	3.4	0.3	0.3	0.5	3.2	2.6
Chemicals	38.3	11.1	13.6	15.6	22.2	11.8
Pharmaceutical Products	19.3	3.3	3.6	6.0	8.3	8.1
Perfumery	2.8	3.4	2.2	2.2	4.1	1.2
Plastics	29.6	3.6	7.1	0.5	1.7	0.3
Textiles	4.0	0.1	0.2	0.6	2.3	0.6
Apparel and Footwear	0.1	0.0	0.1	0.8	0.5	0.3
Food Products	2.9	0.9	1.3	0.9	4.4	5.1
Beverages	2.4	0.8	1.2	4.5	6.9	1.3
Tobacco	0.0	0.0	0.0	0.0	0.9	0.1
Printing and Publishing	2.2	4.4	4.2	2.3	2.0	2.0
Miscellaneous	30.7	13.4	17.9	21.7	28.8	21.1
Total	13.7	6.1	7.1	8.0	11.9	6.8

Source: World Bank, *Brazil: Industrial Policies and Manufactured Exports* (Washington, D.C.: World Bank, 1983), p. 35.

Table III-3

BRAZIL:
MANUFACTURED EXPORT RATIOS IN TOTAL SUPPLY
(Percentages)

	1949	1964	1967	1970	1974	1979
Non-Metallic Minerals	0.2	0.2	0.7	0.8	1.2	1.8
Metallurgy	1.6	1.5	3.6	3.2	1.5	3.7
Machinery	1.5	3.2	5.2	3.6	5.2	14.2
Electrical Equipment	0.2	0.3	0.7	1.4	7.7	4.4
Transportation Equipment	0.1	0.7	0.7	0.7	4.4	9.9
Lumber and Wood	2.0	2.2	3.1	4.2	11.8	8.9
Furniture	---	0.1	0.2	0.3	1.3	0.8
Paper	---	0.7	0.3	0.9	3.7	7.7
Rubber	0.1	2.4	0.3	0.9	1.4	3.4
Leather	2.2	2.0	6.2	13.5	17.8	21.3
Chemicals	16.3	4.1	3.3	5.7	8.0	11.4
Pharmaceutical Products	2.5	0.6	0.8	0.8	1.7	2.5
Perfumery	---	2.0	2.8	0.2	0.5	1.1
Plastics	---	0.3	0.3	0.1	0.2	0.8
Textiles	2.5	0.7	1.0	7.4	10.9	6.5
Apparel and Footwear	---	0.1	0.2	1.0	9.1	7.4
Food Products	2.1	4.3	5.7	13.3	21.1	16.9
Beverages	0.1	0.2	0.2	0.3	2.9	1.8
Tobacco	---	0.3	0.5	11.5	18.5	22.1
Printing and Publishing	---	0.1	---	0.3	0.8	0.6
Miscellaneous	1.0	0.4	0.9	2.2	7.3	7.7
Total	2.3	2.0	2.6	5.7	6.9	9.1

Source: World Bank, Brazil: Industrial Policies and Manufactured Exports (Washington, D.C.: World Bank, 1983), p. 35.

Table III-4

BRAZIL:
SOURCES OF MANUFACTURING DEMAND GROWTH, 1970-79
(Percentages)

	1970-74			1974-79			1970-79		
	IS	EE	DE	IS	EE	DE	IS	EE	DE
Capital Goods	-6.6	8.9	97.6	16.1	10.1	75.8	8.8	10.1	81.1
Intermediate Goods	-11.6	8.1	103.4	14.6	10.1	75.3	6.1	9.0	85.0
Consumer Goods	-5.9	18.4	87.6	2.5	8.1	89.3	0.0	9.1	91.4
Total Manufacturing	-8.4	12.0	96.4	10.4	9.4	80.5	4.3	9.3	86.4

Note: IS = Import Substitution; EE = Export Expansion; and DE = Domestic Demand Expansion.

Source: World Bank, Brazil: Industrial Policies and Manufactured Exports (Washington, D.C.: The World Bank, 1983), p. 39.

This new period of economic growth through import substitution came to an end in 1980, due to the second oil price shock and the shift to a tight money, anti-inflationary monetary policy in the United States, with the resulting surge in global interest rates. As imports increased significantly because of higher prices and booming investment while exports grew only slowly, Brazil accumulated a massive external debt, reaching $100 billion, with interest obligations consuming 40 percent of export earnings. After a period of stop-go economic policies (in 1980-82), Brazil could no longer fend off a severe debt crisis. In 1983, Brazil had to implement a drastic stabilization program involving a severe depreciation of its currency, major reductions in government expenditures, and other conditions imposed by the IMF and foreign banks. The Brazilian economy consequently entered a severe recession (Table III-5), involving large declines in investment and real wages. Imports fell more than one-half in real terms from 1980 to 1984, while exports increased six percent. Exports of primary products actually declined, but exports of manufactures increased rapidly--by 37 percent between 1982 and 1984. These trade shifts enabled the trade balance to change dramatically from a $2.8 billion deficit in 1980 to a surplus of $12-$13 billion in both 1984 and 1985, and, with some assistance from the IMF and foreign banks, Brazil was able to service its foreign debt. The economy did not begin to recover until mid-1985, but then spurted in 1986 under the stimulus of the Cruzado plan, which froze prices and wages at levels that raised real wages by at least 20 percent.

During the period from 1980 through 1986, tight controls were maintained over imports, and the bias against exports was substantially reduced as Brazil pursued the objective of improving the balance of payments. As a result, exports of manufactured goods grew rapidly, especially after 1982 (see Table III-6). Between 1982 and 1984, Brazil:

- Tripled exports of steel by volume and more than doubled them by value;
- Doubled the value of exports of shoes;
- Almost doubled exports of orange juice by volume and tripled them in value.

The larger parts of these exports went to the U.S.

B. Role of Subsidies in Brazil's Economic Policy

The Brazilian government has used many forms of subsidies to promote production and investment. Some were export-oriented; others aimed at import substitution; a substantial number had domestic policy goals. Very few were directed toward personal consumption.

Many of Brazil's export subsidies were designed primarily to offset the distortions due to import protection--that is, they either rebate import

Table III-5

BRAZIL:
ECONOMIC INDICATORS
(Indexes: 1980=100)

	1980	1982	1983	1984	1985
GDP[a]	100	99.4	96.2	100.5	---
GDP Per Capita[a]	100	95.1	90.2	91.9	---
Industrial Production[1b]	100	91.4	86.6	98.0	99.4
Production of Capital Goods[b]	100	65.1	49.5	56.1	64.6
Imports (Constant Prices)[c]	100	72.1	55.6	48.1	---
Exports (Constant Prices)[c]	100	85.4	89.9	106.3	---

Note: 1) In May 1986, industrial production was 112 percent of the 1980 level.

Sources: a) IMF, International Financial Statistics; b) Conjuntura Economica Vol. 40, No. 7; and c) Desempenho do Comercio Exterior Brasiliero, 1984, Funcex, Rio de Janeiro, 1985.

Table III-6

BRAZIL:
RECENT FOREIGN TRADE TRENDS
(Billion U.S. Dollars)

	1980	1983	1984
Imports	23.0	15.4	13.9
Oil	9.4	7.8	6.7
Non-Oil	13.6	7.6	7.1
Exports	20.1	21.9	27.0
Primary Products	8.5	8.5	8.8
Manufactures	11.6	13.4	18.2
Trade Balance	-2.9	+6.5	+13.1
Interest Payments	6.3	9.5	10.1

Source: Desempenho do Comercio Exterior Brasiliero, 1984, Funcex, Rio de Janeiro, 1985.

duties and taxes or attempt to compensate for the negative impact of import quotas on export costs.

Less legitimate, however, in terms of both GATT agreements and U.S. trade law, were Brazilian attempts to compensate for overvaluation of the cruzeiro, sometimes for long periods. Moreover, these subsidies often were not removed when the cruzeiro ceased to be overvalued, except under strong pressure from the United States and other affected foreign countries.

There have also been instances of subsidies designed to aid in the development of export-oriented industries, but these have been relatively few. Since 1979, however, export expansion has become a high priority for Brazil because of the severe debt crisis. Had it not been for strong resistance from the United States and other signatories in the 1979 GATT subsidy code, it is quite likely that the Brazilian government would have used subsidies to promote exports on a very major scale.

Subsidies are also used to promote import-substitution, where tariffs or quotas are inappropriate or inadequate. For example, the Brazilian government heavily subsidizes both the production and the consumption of alcohol as a substitute for gasoline, in order to reduce imports of crude oil.

Brazil also uses a wide range of subsidies in support of other domestically-oriented programs. The most important of these programs is the development of the northeast and the Amazon region through a variety of investment incentives. Tax and other advantages are also given to specific sectors whose development is favored by the government for strategic or economic reasons, such as "informatics."

C. Types of Subsidies*

1. Export Subsidies

Brazil has used a wide variety of instruments to promote exports. Some of these have been in compliance with the GATT subsidy code and U.S. law. Others, however, have not either because they provide excessive rebates or because they involve a specifically prohibited form of assistance. The principal Brazilian export subsidies are described in detail in the annex to this chapter. They are of the following types:

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*In addition to the sources cited earlier, the main sources used in the preparation of this section are the publications of the monitoring system of the Office of the U.S. Trade Representative and the testimony and findings on CVD cases in the U.S. Federal Register.

a) Financial Subsidies

Preferential (below-market) financing of exports has been provided in the form of short- and medium-term loans at below-market interest rates for various programs. The principal program for concessionary export financing include:

- Short-term Brazilian currency financing of inputs used in exports of manufactures (Resolution 674, changed to 883 in 1984).
- Short-term Brazilian currency financing for trading companies (Resolution 643).
- Short-term Brazilian currency financing for manufactured exports with a short production cycle (Resolution CIC_ CREGE 14-11).
- Medium-term U.S. dollar loans, mainly for purchases of imported capital goods (FINEX, Resolution 6.8).

All these programs have been found by the U.S. International Trade Commission to be countervailable.

b) Fiscal Subsidies

Brazil has a complex system of fiscal incentives designed largely or exclusively to promote exports. Although many of them are consistent with GATT principles and U.S. law, others have clearly bestowed fiscal advantages in excess of or unrelated to the indirect tax burden on exports. Some fiscal concessions are available only to specific firms meeting certain policy conditions.

Among the tax concessions that are allowable under U.S. law are:

- Exemption from the Industrial Products Tax (IPT), a federal value-added tax, and the Circulation of Merchandise tax (ICM), a state tax, for exporters and trading companies.
- Suspension of import duties and related taxes (drawbacks) on imports to be incorporated into export products.
- Exemption from the financial operations tax on export operations.

Among the tax concessions that have caused difficulties in Brazil's trade relations are:

- The IPI and ICM export tax credits in excess of the indirect taxes paid on exports (the "Credito Premio Fiscal," or Credit Premium). This program, first introduced in 1969, was suspended after the 1979 devaluation, but was then reintroduced in April 1981 because of the renewed appreciation of the currency, but with a timetable for phasing out. It was eliminated in May 1985. It was used as a flexible means of keeping exports profitable during periods when the currency was overvalued. In recent years, the credit was available at a uniform rate to all exporters.

- The exemption of profits on the export sales of certain firms from the profits tax of 35 percent. This program expired at the end of 1985.
- The exemption from the IPI, and ICM taxes and import duties on imports of capital equipment in relation to export performance (indirect taxes on capital goods are not deductible under U.S. law because they are not physically incorporated into exports).
- The Special Program for Fiscal Incentives (BEFIEX), and the similar, but smaller program for small firms (CIEX), which provide various tax concessions to firms, including multinational companies, in priority industries. The benefits include: large tax reductions on imports of machinery and equipment; reductions of taxes on imports of materials and components in excess of those actually used in exports; exemption from profits taxes on exports. In order to qualify for these concessions, enterprises must negotiate long-term programs for export development with the government.

2. Domestic Subsidies

Brazil uses a wide variety of domestic subsidy programs, some of which have indirect effects on exports. The principal programs are:

- Concessionary loans to promote scientific and technical development (ADTEN and FINEP). These concessions have not been sources of trade dispute.
- Concessionary loans, tax rebates, and other benefits for firms locating in the depressed Northeast region and in the Amazon region. These concessions have not been sources of trade disputes.
- Direct budgetary subsidies to cover the excess of production costs over the controlled prices of methyl alcohol. To encourage the substitution of domestically-produced alcohol for gasoline produced mainly from imported oil, the price of alcohol has been set at 60 percent of the price of gasoline--well below production costs, even though Brazil is a very efficient producer of alcohol. A glut in the domestic alcohol market during 1981-85, due to the depressed production of automobiles, pushed the Brazilians to export methanol to the U.S. at a subsidized price. Faced with countervailing duty actions, and a U.S. $0.60 a gallon surcharge that raises the U.S. tariff *ad valorem* equivalent of over 50 percent, the Brazilians ceased exports of methanol.

D. Trade Disputes Involving Brazilian Subsidies

Brazilian subsidies became a major source of trade disputes with the United States in the mid-1970s when Brazilian exports of manufactured goods began to penetrate the U.S. market on a substantial scale. The Brazilian government made increasing use of subsidies to sustain export growth. Between 1974 and 1979, until Brazil's qualified acceptance of the 1979 GATT subsidy code, ten categories of Brazilian products were subject to U.S. countervailing duty proceedings. New countervailing duty proceedings against Brazilian products began in 1980 and 1981, when some of the troublesome subsidies were reinstated. In 1982, countervailing duty cases were initiated on 14 Brazilian products, 10 of which were steel products. This reflected the reinstitution of subsidies, plus continued rapid growth of certain Brazilian exports to the United States, at a time when the U.S. market was severely depressed by the 1982 recession. It also reflected the enhanced opportunities for successful litigation on subsidies cases due to the 1979 Trade Agreements Act.

Brazilian subsidies continued to be a major source of trade disputes from 1983 through 1985. The programs that were most often subject to countervailing duty litigation were Industrial Product Tax (IPI) rebates and export credits, preferential working capital financing for exports, and income tax exemptions for exports, as shown in Table III-7. The countervailing duty cases against Brazilian steel products were dropped in 1985, however, upon negotiation of the voluntary export restraint agreement on steel exports to the United States between the U.S. and several LDCs, including Brazil.

Litigation over "unfair" Brazilian trade practices increased during the late 1970s and early 1980s, not only in the United States, but also in Western Europe and other industrial countries. Few of these cases outside the United States, however, involved allegations of subsidies' most of them involved charges of dumping. This is not to say that Brazilian subsidies were of no concern to these other industrial countries, but rather that their governments preferred to deal with trade problems either through dumping cases or through informal agreements and restrictions.

E. Impact of Brazilian Subsidies

Brazilian subsidies are both a cause and a consequence of the severe price distortions in the Brazilian price structure. These price distortions reflect a generally high and uneven level of import-protection, an often overvalued currency, and attempts to favor priority sectors. They reflect generally inward-looking policies on the part of a highly interventionist government. These policies, together with other government economic activities and controls, have created substantial inefficiencies and led to recurrent economic crises and alternating periods of slow and rapid growth. Although subsidies were partly designed to offset price distortions, they must be considered to have contributed to distortions.

Table III-7

BRAZILIAN SUBSIDY PROGRAMS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Total # of Cases	24	18
Programs:		
IPI Rebates for Capital Investment	9	6
Federal IPI Export Credit Premium	15	11
Preferential Working Capital Financing for Exports--Resolution 674	17	15
Income Tax Exemption for Export Earnings	15	14
Accelerated Depreciation	13	3
Regional Development Investment Subsidy	3	
Long-Term Loans	4	3
Transportation Subsidy	7	
Income Tax Deduction for Employee Training and Meals	2	
BEFIEX	13	2
CDI	10	4
Deductions from Income Tax for Foreign Market Expenditure	1	
Export Financing under Communication 331	4	
Subsidized Feedstock	1	
Export Financing under Resolution 68-FINEX	9	
Exemption From State Value-Added Tax (ICM)	1	

Table III-7 (Continued)

BRAZILIAN SUBSIDY PROGRAMS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Exemption From Federal Industrial Products Tax (IPI	3	
State Value-Added Tax (ICM) Export Credit Premium	2	
Government Purchase of Equity	2	
Resolution 330	9	
Preferential Export Financing under CIC-GREGE 14-11	10	7
CIEX	9	2
Resolution 643	8	2
Gold Draft of Exploration	1	
Government Provision of Equity Capital	2	1
Government Guarantees on Long-Term Loans	3	1
Raw Material Subsidies	1	
BNDES Financing	2	
FINAME Loans	2	
Government Assistance in Repaying Foreign Loans 588	1	
Supplier Credits	1	
Labor Programs	1	
Donations and Grants	1	
Preferential Utility Rates	1	
Government Funding to Cover Operating Losses	1	

Table III-7 (Continued)

BRAZILIAN SUBSIDY PROGRAMS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Local Tax Incentives	2	
Construction of Ports	2	
PROEX	7	
Partially Indexed Long-Term Loans	1	
Remission of Indirect Taxes Applied to Exports	1	
ADTEN Loans	2	1
Mineral Tax Incentives	1	1
Depletion Allowance	1	
PROALCOOL Industrial Credit	1	1
IAA Preferential Financing	1	1
PROALCOOL Agricultural Loans	1	1
PLANALSUCOR	1	
PETROBRA Storage Assistance	1	
PETROBRAS Preferential Payment Terms	1	
Cost Equalization Program	1	
SUDENE	1	
Plantation Roads	1	
Research and Development Assistance	1	
FUNPROCUCAR	1	

Source: Documentation on subsidy cases obtained from the United States Department of Commerce's Central Records Information Management System.

It is not possible to quantitatively estimate the impact of Brazilian subsidies on exports, because it cannot be isolated from other major influences, especially exchange rates. What seems evident, however, is that subsidies have been an important means of sustaining export growth, thereby keeping production near capacity levels. In the case of steel products, for example, export volume grew some four and a half times from 1980 to 1983, roughly offsetting an almost 40 percent drop in domestic consumption.

IV. INDIA*

A. Characteristics of India's Economic Policy

The Indian economy, especially Indian industry, has been enmeshed in a tight web of government controls since the mid-1950s. The government:

- establishes economic plans;
- owns and operates substantial parts of key industries (such as steel);
- spends one half of total investment expenditures;
- allocates foreign exchange to ministries and enterprises;
- licenses and limits imports;
- licenses any substantial new domestic enterprise or even the expansion of capacity in existing enterprises;
- controls the prices of many basic goods; and
- generally surrounds private enterprises with a complex set of regulations and paperwork.

There is no doubt that government controls on the private sector, coupled with the inefficiency of many government enterprises, have been partly responsible for India's relatively slow rate of economic growth--only 3.5 percent per capita between 1950 and 1985.

This heavy reliance on government planning and control has deep roots in Indian political and social history and reflects government priorities that often take precedence over economic growth. India's extreme ethnic and demographic complexity, the poverty of most of its people, and a regime of generally democratic institutions, combine to make Indian governments highly sensitive to social and regional problems. India's inheritance of a British-type civil service, plus the influence of socialist ideas, plus the association of capitalism with colonialism, all combined to encourage reliance on the state for economic development. These influences were strengthened by India's increasingly close relations with the USSR in the 1960s, and by what was then widely viewed in the Third World as the effectiveness of the Soviet economic system as a mechanism for economic development.

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*The principal sources used in this chapter are: Jagdish N. Bhagwati and T. N. Srinivasan, Foreign Trade Regions and Economic Development: India (New York: National Bureau for Economic Research, 1975); Martin Wolf, India's Exports (New York: Oxford University Press, 1982; United Nations Industrial Development Organization, Industrial Development Review Series - India (5 July 1985); V. R. Pauchanukhi, Trade Policies of India (New Delhi: Concept Publishing Co., 1978); Dipak Mazumdar, The Issues of Small versus Large in the Indian Textile Industry (World Bank Staff Working Papers No. 645); and James Riedel, Chris Hall and Roger Grawe, "Determinants of Indian Export Performance in the 1970s," Weltwirtschaftliches Archiv, Vol. I, 1984, pp. 40-62.

Over the years, the principal objectives of the Indian government included:

- industrialization, which largely took the form of state investments in basic industries, such as steel, electric power, and machinery.
- stabilization of the prices of basic foodstuffs, especially grain.
- promotion of agricultural development.
- protection of small-scale, handicraft type industry in order to create employment, or at least avoid a decline in employment.
- encouragement of the development of the poorest and least industrialized areas of India through a wide variety of benefits.
- reduction of energy imports through development of domestic energy sources.
- development of the heavy industries needed for military production.

India's industrial development has occurred through a process of import-substitution. Except in periods of severe foreign exchange constraints, export growth has not been a major objective of the Indian government. Imports have been subject to tight quantitative restrictions as well as high tariffs. In 1970, about two-thirds of dutiable imports had tariffs of over 75 percent ad valorem, but imports were restricted even more severely by the system of licensing and foreign exchange allocations. Licenses were not granted for imports of goods that were or could be produced domestically. Moreover, even if a domestic product was not available, imports had to be financed out of a generally inadequate foreign exchange allocation that was assigned to each firm by the appropriate ministry, and each transaction met with long delays. As a result of all this, net effective rates of protection on almost all industries were very high, as shown in Table IV-1. By the same token, the net effective value of the rupee was consistently much higher for exports than for imports, by 20 to 30 percent, which put exporters at a severe disadvantage. Not surprisingly, exports constituted only about six percent of GDP in 1984, up only slightly from five percent in 1960.

The Indian government has coupled its highly interventionist microeconomic policies with generally conservative macroeconomic policies. India has avoided large, sustained budget deficits, excessive increases in domestic credit, or a large accumulation of foreign debt. Except during years of

Table IV-1

INDIA:
RATES OF EFFECTIVE PROTECTION: 1968

	Rate (%)	Rank
Electrical Equipment	119.6	20
Non-Electrical Equipment	87.8	24
Transport Equipment	61.2	28
Metal Products	133.5	16
Iron & Steel	151.9	13
Cement	43.8	31
Non-Ferrous Metals	37.9	32
Leather Products	120.0	19
Leather Footwear	124.0	18
Sugar	235.1	6
Vegetable Oils	139.5	14
Milk Products	521.8	3
Breweries & Soft Drinks	81.6	25
Biscuits & Confectionary	644.1	1
Cigarettes & Cigars	113.5	21
Fruit & Vegetable Products	179.8	9
Cotton Textiles	223.7	8
Jute Textiles	457.3	5
Woolen Textiles	230.2	7
Fertilizers	461.8	4
Ceramics & Bricks	62.5	27
Glass & Glassware	47.7	30
Wood Products	89.3	23
Chinaware & Pottery	125.9	17
Petroleum Products	535.1	2
Tires & Tubes	59.7	29
Other Rubber Products	135.6	15
Paper & Paper Products	171.3	10
Plastics	166.2	11
Drugs & Pharmaceuticals	68.8	26
Soap, etc.	165.8	12
Miscellaneous Chemicals	104.1	22

Source: Jagdish Bhagwati and T.N. Srinivasan, Foreign Trade Regimes and Economic Development: India, (New York: National Bureau for Economic Research, 1975).

severe crop failures, inflation in India has been no higher than in the industrial West and much lower than in most other large developing countries. The Indian rupee has been consistently overvalued, but this was due more to the severely controlled foreign trade regime than to major macroeconomic imbalances. Since the mid-1970s, the rupee has about maintained its real purchasing power in terms of foreign currencies.

Although the weight of government regulation remains heavy, and the bias favoring the domestic market over exports continues, there has been a very slow, halting trend toward economic liberalization over the past 20 years or so. The drive toward a centrally planned economy based on large-scale investments by the state stopped in the mid-1960s when an agricultural crisis diverted large amounts of foreign exchange away from industrial development toward massive importation of food. A brief period of fairly rapid growth in the late 1960s was again interrupted in 1972-74 by renewed crop failures, as well as the dramatic increase in oil prices. Agricultural production was subsequently given a high priority in the allocation of investment, and as a result, India attained self-sufficiency in food grains in the early 1980s. Industrial growth, held back by the 1979-80 oil shock, increased during the early 1980s, although capacity utilization remains low in many heavy industries.

Since 1983, the government has taken a number of steps to liberalize the economy. These steps include: open licensing for a larger number of imports, including most imports of capital goods; greater flexibility for exporters to use their foreign exchange earnings to purchase imported inputs; a reduction in domestic price controls; a simplification of procedures for approving new investments and expansions of capacity; and encouragement of joint ventures with foreign enterprises. These reforms do not constitute a fundamental change in the Indian economic system, but are clearly more far-reaching than any earlier attempts at liberalization.

The severe bias in the Indian economy favoring domestic sales over exports has resulted in slow export growth. In the 1950s, exports (in constant prices) were stagnant, while production increased rapidly. In the 1960s, exports grew, but less quickly than production. Since 1970, exports have increased about proportionally to GDP and industrial production (Table IV-2).

Indian exports are highly diversified, with manufactures making up more than one-half the total. The bulk of manufactured exports consist of traditional products such as textiles, clothing, and leather goods. Exports of steel, machinery, and chemicals have grown mainly in response to declines in domestic demand and have gone almost exclusively to developing countries, not to the industrial west (Table IV-3). Even in developing country markets, India has had to offer large price discounts in order to sell its machinery and steel. And in the Middle East in particular, with oil incomes now far below the levels of the early 1980s, Indian industrial exports appear to be declining.

Table IV-2

INDIA: EXPORTS, GDP, AND INDUSTRIAL PRODUCTION
(Volume Indexes: 1980 = 100)

	Exports	GDP	Industrial Production
1950/51	48	40	20
1960/61	46	59	36
1970/71	69	84	69
1980	100	100	100
1983	117	118	119

Sources: Exports through 1979 from Martin Wolf, *India's Exports*, (New York: Oxford University Press, 1982), p. 170; Exports for 1979-83 from *International Financial Statistics* (Export Value in rupees deflated by export price index); GDP from *World Bank* publications; Industrial Production from United Nations Industrial Development Organization, *Industrial Development Series: India.*

Table IV-3

INDIA: EXPORT OF MANUFACTURES, 1980

	Million Dollars	Percent of Total Exports			
	Total	Total	Industrial Countries	LDCs	Centrally Planned Economies
Meat and Products	66	0.9	0.2	0.7	—
Sugar and Produce	47	0.6	0.3	0.3	—
Tea	452	6.0	1.3	2.1	2.1
Rice	154	1.2	0.2	0.7	0.3
Cotton	177	2.4	0.7	1.1	0.6
Chemicals	314	4.2	0.8	0.9	2.5
Leather Goods	405	5.4	3.2	0.3	1.9
Textiles	1,141	15.2	8.5	3.0	3.7
Non Metallic Min. Manuf.	631	8.4	6.9	1.4	—
Iron and Steel	85	1.1	0.2	0.8	0.1
Other Metal Products	219	2.9	1.1	1.7	—
Machinery and Equipment	622	8.3	1.1	6.4	0.8
Clothing	590	7.8	5.7	0.9	1.2
Miscellaneous Manufacturing	220	2.9	1.8	0.8	0.3
Total Manufacturing	5,632	75.0	35.9	24.0	14.2
Total Exports	7,511	100	49.8	28.7	20.3

Source: Calculated from Table 11 from United Nations Industrial Development Organization, Industrial Development Review Series - India.

B. Role of Subsidies in India's Economic Policy

The Indian government has used subsidies as important instruments of policy. Farmers have been subsidized to sustain agricultural incomes and to promote increased output. The government has covered the losses of state enterprises. Industries in backward regions of the country have been subsidized. And exports have sometimes received large subsidies in order to compensate for the unfavorable effects of import substitution policies on their costs.

Export subsidies and other forms of assistance increased rapidly after the mid-1970s, from $111 million in 1974-75 to $511 million in 1978-79, when they were equivalent to about eight percent of the value of total exports, after deducting export taxes (Table IV-4). These export subsidies consisted mainly of rebates of indirect taxes and import duties, as well as more indirect ways of offsetting the high cost of imported inputs. There is little question that in most industries export subsidies have not fully offset the negative impact of protectionist policies on export costs. The high level of protection of almost all domestic industries has put them at a severe disadvantage in exporting, except for state-owned enterprises, which could be subsidized directly from the government budget. These enterprises were able to charge prices to LDC customers that were far below their average cost and perhaps even below their marginal cost.

Domestic subsidies also have been large, but they have fluctuated, according to crop conditions and budget priorities. These subsidies are both direct, in the form of cash transfers, and indirect, in the form of price supports and subsidized inputs. There are also what might be called implicit subsidies, such as severe limitations on production of certain kinds of cotton fabrics in large textile mills, in order to prevent competition with cotton fabrics produced with hand looms in the traditional sector. In a sense, subsidies to either the seller or the buyer are inherent in the entire web of government controls.

C. Types of Subsidies*

1. Export Subsidies

India has used a large variety of export subsidies over the years. The principal types are the following:

- The Cash Compensatory Support (CCS) System. The CCS is the most important type of export subsidy. It is designed to compensate for indirect taxes paid by exporters, but not reimbursed as an import

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*In addition to the general sources cited earlier, the main sources used in the preparation of this section are the publications of the USTR monitoring system of the Office of the U.S. Trade Representative and the testimony and findings on countervailing duty cases in the Federal Register.

Table IV-4

INDIA:
TRADE INCENTIVES AND TAXES, 1973/74 TO 1979/80

Incentives	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80
	Millions of U.S. Dollars						
Foreign Trade & Export Promotion	99.5	110.8	185.7	322.9	405.1	511.6	473.6
Cash Assistance	51.0	61.3	98.0	157.9	263.9	378.1	370.6
Duty Drawbacks	53.9	75.2	92.5	134.2	155.3	182.8	n.a.
Replenishment Licenses (REPs)	194.1	208.6	212.7	464.8	865.8	1,336.5	1,349.1
Excluding Gems and Jewelry	114.1	137.3	158.7	270.0	468.4	598.8	791.9
Premiums on Replenishment Licenses	41.4	34.5	31.7	27.0	46.8	59.9	79.2
Export Taxes	-109.2	-113.6	- 96.2	-144.7	-266.9	-171.2	-156.3
Import Duties	1,196.1	1,548.9	1,572.0	1,628.8	1,922.3	2,684.8	3,407.4
Total Incentives	194.8	220.5	309.9	484.1	607.2	754.3	n.a.
Net Incentives	85.6	106.9	213.7	339.4	340.3	583.1	n.a.
	Percent						
Export Tax Rate	-3.4	-2.7	-2.1	-2.5	-4.2	-2.5	-2.0
Total Incentive Rate	6.0	5.3	6.6	8.4	9.6	10.8	n.a.
Net Incentive Rate	2.6	2.6	4.6	5.9	5.4	8.4	n.a.
Import Duty Rate	31.5	27.3	25.8	28.7	27.3	32.3	31.3

Source: Calculated from Table 11 from United Nations Industrial Development Organization, Industrial Development Review Series - India.

and excise tax duty refund. In practice, however, it is also used to cover the difference between the marginal cost and the export price of some exporters. The subsidy rates generally have ranged from 5-20 percent of the value of exports and were very unevenly distributed among industries: 35-50 percent went to engineering products, with substantial assistance also provided to chemicals, paper, and synthetic fibers. The CCS has been a source of major difficulty with the U.S., because the connection between indirect taxes paid and the cash rebates under the program was often extremely vague.

- Import and Excise Tax Duty Refunds. This is the second largest export subsidy; it is designed to repay the exporter for import duties on inputs used in export production. The highest share went to iron and steel products, engineering goods, and textile manufacturers.

- Import Replenishment Licenses. The assignment of import licenses to exporters to cover their requirements for imported inputs provides opportunities to sell goods at a large profit in the domestic market, since firms could get licenses for imports that may exceed actual export requirements. Such "excessive" licenses were allocated in a very selective manner, giving priority to the machinery industries.

- Other export subsidies include: allocation of raw materials to exporters at close to world market prices (below domestic prices); subsidized freight rates (until 1980); preferential medium-term export financing from the Industrial Development Bank of India at below-market rates; preshipment export loans for short-term financing of imports of raw materials at below market rates; market development assistance; special income tax exemptions for certain capital investments and for overseas expenses; and special tax and licensing concessions for free trade zones.

2. Domestic subsidies

- Food subsidies, mainly on grain, have been designed to help the states maintain adequate buffer stocks to protect their population against harvest failures and to stabilize the prices of basic foods. Food subsidies grew rapidly through the 1970s.

- Besides maintaining a fairly high and relatively stable price for food grains, the Indian government has subsidized both domestic and imported fertilizer, in order to encourage its use by farmers.

- Regional industrial development incentives for investment in the least industrialized parts of India include: an investment subsidy of up to 15 percent of the value of the investment (concessionary interest rates on loans or longer than normal amortization periods);

a transport subsidy to cover part of the cost of transportation to inaccessible areas; income tax deductions; discounts on government purchases; and reduced rates on electric power.

D. Trade Disputes Involving Indian Subsidies

India has played an important role in GATT negotiations, especially since the mid-1970s, but this role is due more to India's posture as a leader of the Third World than to its own foreign trade interests. Although India was a signatory of the GATT Tokyo Round agreements on subsidies, it attached major qualifications to its agreement. In particular, the Indians indicated that they intended to reduce the use of export subsidies, but only "whenever the use of such subsidies is inconsistent with its (India's) competitive or development needs."*

The growth of Indian manufactured exports to the United States and other industrial countries has been too small to generate much of a reaction; between 1979 and 1985, countervailing duty cases were brought against only five categories of Indian products in the U.S., and no such cases were raised in any other industrial country. Compensatory duties were imposed in four cases: leather footwear, oleo, raisins, manhole covers, and industrial fasteners. The only substantial export among these items was leather footwear.

The Indian subsidy program that created the greatest difficulty by far in all these cases was the Cash Compensatory Program (CCS). The problem appears to have been that this program attempted to compensate, in one lump sum, for a wide variety of indirect taxes. Thus, in response to CVD cases, it was difficult to demonstrate specifically how these indirect taxes affected the cost of imported inputs used in exports. Well-organized Indian textile producers were able to obtain detailed information on the incidence of indirect taxes on their costs. Less well-organized producers of leather footwear, fasteners, and manhole covers were unable to make a clear link, and consequently the CCS program was found to be countervailable in those cases. Also found countervailable in several cases, although by very small margins, were preshipment export loans, certain tax deductions for export marketing expenses, and payments through the Market Development Assistance Program. (Programs investigated in U.S. CVD cases are summarized in Table IV-5.)

Despite these recent cases, however, India's trade policy difficulties due to its export subsidies have been quite minor. Even though Indian exports are probably subsidized in accordance with a strict interpretation of U.S. law and regulations concerning subsidies, most of them are still not generally competitive in world markets. The subsidies do not fully offset the disadvantages due to import protection.

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*Declaration of the Indian government, September 25, 1981, from Hufbauer and Erb, Subsidies in International Trade, op. cit., Appendix B, pp. 167-68.

Table IV-5

INDIAN SUBSIDY PROGRAMS: U.S. INVESTIGATIONS

	Number of Times Cited	Number of Times Case and/orProgram Program Found C.V.
Total # of Cases	7	4
Programs:		
Cost Compensatory Support Program (CCS)	5	4
Pre-shipment Export Loans Program	2	2
Export Markets Development Allowance - Income Tax Deductions	3	3
Market Development Assistance Program	2	1
Short-Term Preferential Financing	1	1
Income Tax Deduction for Overseas Business Expenses	1	1
Sales of Import Replenishment Licenses	2	
Extension of the Kandla Free Trade Zone	2	
Raw Materials at Subsidized Prices	1	
Preferential Rail Rates	1	
Income Duty Exemptions on Capital Equipment Purchases	1	
Preferential Export Financing	1	1
Import Permits	1	
Tax Deductions for Capital Equipment on New Industrial Undertakings	1	
Packing Credit Program	1	1
Regional Benefits to New Facilities in Madhya Pradesh	1	

Source: Office of the U.S. Trade Representative. Trade Action Monitoring System; and documentation obtained from the United States Department of Commerce's Central Records Information Management System.

E. Impact of Indian Subsidies

As mentioned, subsidies in India are an integral part of the elaborate system of government controls. The economy continues to suffer from a fairly severe, if somewhat reduced, bias favoring sales to the domestic market over export sales, preventing exports from being profitable without subsidies. Without them, foreign exchange earnings would have grown even less quickly, and India's economic growth would have been further arrested by a shortage of foreign exchange. Subsidies have favored manufacturers, especially of machinery and chemicals. The net incentives provided to these industries were equivalent to 20-30 percent of the value of exports in the mid- and late 1970s, whereas food and raw material exports were heavily taxed (Table IV-6).

There is no question that the elaborate set of government controls that necessitated these subsidies has greatly hampered economic growth, even though the controls may have contributed to India's political stability. Economic growth has been stimulated since the mid-1970s by a big improvement in agricultural policies and more recently by a degree of economic liberalization. The economy has grown about five percent per year since 1980, compared with three and one half percent in the previous two decades. But this growth does not appear to be self sustaining. Exports of primary products are sluggish and likely to remain so. Exports of traditional manufactures such as textiles and clothing are limited by quotas and lack of modernization. Most exports of heavy industrial products have gone to LDC markets; because of low oil prices these are declining, and are likely to remain weak for some time. And exports of new manufacturers to industrial markets are very small and show no sign of rapid growth. It is highly likely, therefore, that India's economic growth will slow substantially during the next few years, unless India finds some way of increasing its manufactured goods exports to the industrial West much more rapidly than in the past. Should it try to do this despite the current anti-export bias in the Indian price structure, much larger subsidies will be needed, and these would certainly generate major trade frictions.

Table IV-6

INDIA:
EXPORT INCENTIVES AND TAXES, BY BROAD EXPORT CATEGORIES, 1973/74 TO 1979/80
(Millions of U.S. Dollars and Percent)

Export and Incentives	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80
Food and Beverages							
Exports	962.4	1,380.7	1,562.5	1,570.6	1,929.2	1,918.0	n.a.
Export Taxes	-33.1	-27.5	-34.6	-80.8	-212.8	-113.0	-88.5
Cash Assistance	2.6	0.8	9.5	15.3	22.2	37.2	30.8
Duty Drawbacks	—	—	—	—	—	—	—
REP Premiums	5.3	4.6	4.0	3.3	4.2	5.2	6.7
Total Incentives	7.9	5.4	13.5	18.6	26.4	42.4	37.5
Net Incentives	-25.2	-22.1	-21.1	-62.2	-186.4	- 70.6	-51.0
Tax Rate (Percent)	- 3.4	- 2.0	- 2.2	- 5.1	- 11.0	- 5.9	n.a.
Total Incentive Rate (Percent)	- 0.8	0.4	0.9	1.2	1.4	2.2	n.a.
Net Incentive Rate (Percent)	- 2.6	- 1.6	- 1.4	- 4.0	- 9.7	- 3.7	n.a.
Raw Materials (Including fuel)							
Exports	526.0	610.3	714.3	768.6	626.0	669.8	n.a.
Export Taxes	-33.9	-29.7	-29.1	-28.8	- 28.0	- 32.4	-39.8
Cash Assistance	—	—	—	—	—	—	—
Duty Drawbacks	—	—	—	—	—	—	—
REP Premiums	—	—	—	—	—	—	—
Total Incentives	—	—	—	—	—	—	—
Net Incentives	-33.9	-29.7	-29.1	-28.8	- 28.0	- 32.4	-39.8
Tax Rate (Percent)	- 6.4	- 4.9	- 4.1	- 3.7	- 4.5	- 4.8	n.a.
Total Incentive Rate (Percent)	—	—	—	—	—	—	n.a.
Net Incentive Rate (Percent)	- 6.4	- 4.9	- 4.1	- 3.7	- 4.5	- 4.8	n.a.
Manufactures							
Exports	1,750.6	2,182.5	2,395.5	3,414.0	3,760.3	4,388.4	n.a.
Export Taxes	- 45.8	-60.1	-35.4	-33.9	- 28.3	- 28.4	-28.5
Cash Assistance	65.5	74.3	88.5	142.5	241.7	340.8	339.5
Duty Drawbacks	53.9	75.3	92.5	134.2	155.3	182.8	n.a.
REP Premiums	36.5	30.0	27.7	23.6	42.6	55.0	71.8
Total Incentives	155.9	179.6	208.7	300.3	439.6	578.6	n.a.
Net Incentives	110.1	119.5	173.3	266.4	411.3	550.2	n.a.
Tax Rate (Percent)	- 2.6	- 2.8	- 1.5	- 1.0	- 0.8	- 0.6	n.a.
Total Incentive Rate (Percent)	8.9	8.2	8.7	8.8	11.7	13.2	n.a.
Net Incentive Rate (Percent)	6.3	5.5	7.2	7.8	10.9	12.5	n.a.

Table IV-6 (Continued)

Export and Incentives	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80
Chemicals							
Exports	74.7	130.0	105.2	133.1	146.0	187.4	n.a.
Export Taxes	—	—	—	—	—	—	—
Cash Assistance	11.3	15.2	12.7	20.4	34.1	41.3	35.3
Duty Drawbacks	1.0	1.0	1.3	1.7	2.3	2.9	n.a.
REP Premiums	9.2	7.3	5.7	4.7	8.5	6.9	7.8
Total Incentives	21.5	23.5	19.7	26.8	44.9	51.1	n.a.
Net Incentives	21.5	23.5	19.7	26.8	44.9	51.1	n.a.
Tax Rate (Percent)	—	—	—	—	—	—	—
Total Incentive Rate (Percent)	28.8	18.1	18.7	20.1	30.8	27.3	n.a.
Net Incentive Rate (Percent)	28.8	18.1	18.7	20.1	30.8	27.3	n.a.
Machinery and Transport Equipment							
Exports	151.9	270.8	300.5	337.9	393.6	481.5	n.a.
Export Taxes	—	—	—	—	—	—	—
Cash Assistance	18.2	24.1	26.0	41.9	65.1	94.1	87.8
Duty Drawbacks	9.4	14.0	17.2	25.5	32.3	39.2	n.a.
REP Premiums	8.8	7.3	8.4	5.9	9.6	12.3	16.2
Total Incentives	36.4	45.4	51.6	73.3	107.1	145.6	n.a.
Net Incentives	36.4	45.4	51.6	73.3	107.1	145.6	n.a.
Tax Rate (Percent)	—	—	—	—	—	—	—
Total Incentive Rate (Percent)	24.0	16.8	17.2	21.7	27.2	30.2	n.a.
Net Incentive Rate (Percent)	24.0	16.8	17.2	21.7	27.2	30.2	n.a.
Other Manufactures							
Exports	524.0	1,781.7	1,989.8	2,943.0	3,220.7	3,719.5	n.a.
Export Taxes	-45.8	-60.1	-35.4	-33.9	-28.3	-28.4	-28.5
Cash Assistance	36.0	35.0	49.8	80.2	142.4	205.4	216.4
Duty Drawbacks	43.5	60.3	74.0	107.7	120.7	140.7	n.a.
REP Premiums	18.5	15.4	13.6	13.0	24.5	35.8	47.8
Total Incentives	98.0	110.7	137.4	200.3	287.6	381.9	n.a.
Net Incentives	52.2	50.6	102.0	166.4	259.3	353.5	n.a.
Tax Rate (Percent)	- 3.0	- 3.4	- 1.8	- 1.2	- 0.9	- 0.8	n.a.
Total Incentive Rate (Percent)	6.4	6.2	6.9	6.8	8.9	10.3	n.a.
Net Incentive Rate (Percent)	3.4	2.8	5.1	5.7	8.1	9.5	n.a.

Source: Calculated from Table 11 from United Nations Industrial Development Organization, _Industrial Development Review Series - India_.

V. INDONESIA*

A. Characteristics of Indonesia's Economic Policy

Indonesia is a large, relatively underdeveloped country with a classic dual economy: a modern sector, largely financed by oil exports, superimposed on a largely underdeveloped rural economy which includes most of the population. Primitive conditions and poor transportation and communication among the country's numerous islands have helped create segmented markets. Large income from oil exports has been the primary financial resource for government functions, infrastructure construction, and industrial development, especially the creation of large state enterprises. These activities have created few deep backward linkages into the economy. The Indonesian government has avoided the major policy pitfalls that have been so prevalent in the large oil exporting countries (such as Mexico or Venezuela)--namely, allowing its currency to become grossly overvalued in relation to any export product except petroleum, in order to hold down import prices and sustain urban real wages. Although there has been considerable inflation, and Indonesia has allowed its currency to appreciate in real terms, it has periodically devalued in order not to destroy its non-oil export industries or make it impossible to develop new exports. Moreover, international debt has been restrained to manageable levels, although the recent drop in oil prices has raised considerable concerns about debt servicing. But, the extensive government regulations and controls that cover virtually all economic activity have created massive rigidities in Indonesia's economy. The restrictions reflect the traditional Indonesian _dirigisme_ and distrust of the market.

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*This chapter draws on a variety of sources. In particular, the research on Indonesia for this project was undertaken jointly with another Hudson Institute project, Trade Policy Formulation in Selected Developing Countries. See the final report by the same name by J.W. Wheeler and Perry L. Wood (Indianapolis, IN: Hudson Institute, April 1986) and a background paper, by Perry L. Wood and Philip J. Deluty, "Indonesia: Trade Policymaking in a Patrimonial State," Hudson Institute Paper HI-3824-P, March 26, 1986. See also: Anne O. Krueger, Hal B. Lary, Terry Monsen, and Narongchai Akrasanee (eds), Trade and Employment in Developing Countries, three volumes. (Chicago and London: University of Chicago Press, 1981); United Nations Industrial Development Organization, Indonesia, UNIDO/IS.458 (18 April 1984); Gustav F. Papanek (ed.), The Indonesian Economy (New York: Praeger Publishers, 1980); Kuhn Loeb Lehman Brothers International, Inc., Lazard Freres et Cie., and S.G. Warburg & Co. Ltd., The Republic of Indonesia (December 1985); idem, Recent Developments in the Economy (July 1986); F.M. Bunge (ed.), Indonesia: A Country Study (U.S. Army, 1983); U.S. Department of Commerce, Foreign Economic Trends and Their Implications for the United States, semiannual series, various issues; United Nations Industrial Development Organization, Prospects for Industrial Development and for a Capital Goods Industry in Indonesia, three volumes, UNIDO/IS.479 (20 July 1984); Thee Kian Wie, "The Resources Boom and Industrial Development in Indonesia since 1966," LEKNAS-LIPI, Jakarta, presented at the Second Project Workshop on Economic Development Models for Resource Rich Countries, Bangkok, 5-7 December 1985; and Mari Pangestu and Boediono, "The Structure and Causes of Manufacturing Sector Protection in Indonesia," Draft, undated, includes some information through 1984.

Indonesia's large domestic market and oil income have supported a highly protectionist industrial and trade policy that is focused on import substitution as the primary means of stimulating industrialization. Although the recent decline in oil prices has forced the introduction of some policy reforms, the resistance to liberalization remains strong. Important political and business interests benefit from the detailed government intervention and high levels of protection. Moreover, there is a strong national ideology that reflects suspicion of international trade and investment.

Indonesia's industrial and trade policy is characterized by high and uneven tariffs, tight quantitative restrictions, and detailed intervention at all levels of decisionmaking. It has one of the highest nominal and effective rates of protection in South and East Asia, although the level of protection has declined since the mid-1970s.* The import-substitution industrialization that has taken place behind these high barriers has been capital-intensive, has generated little employment, and has generally been inefficient and uncompetitive. Not only are the official administrative procedures complex, but there is also a broad range for administrative discretion, which has resulted in pervasive abuse and graft. (Table V-1 provides an impression of the complexity of the policy process.)

The Indonesian economy has undergone some major shocks during the past decade (Table V-2). The leap in world crude oil prices in the 1970s caused oil exports to rise from less than one-fifth of export earnings to between one-half and three-fifths. This oil wealth permitted a sharp increase in imports to improve domestic food consumption and provide raw materials and capital equipment for domestic infrastructure and productive investment.

Macroeconomic controls became less restrictive. Government expenditures, funded by oil revenue, increased the money supply and inflation, and permitted the government to avoid implementing necessary but politically difficult reforms. The easy money also supported increased corruption, underwrote economic inefficiency, and promoted excessive regulation. It further permitted large capital-intensive development projects to be pursued, despite clear indications that labor-intensive industrialization offered greater economic potential.

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*For estimates through 1980 and a discussion through 1983-4, see Pangestu and Boedino, op. cit.

Table V-1

INDONESIA:
POLICY INSTRUMENTS HAVING POTENTIAL PROTECTIVE EFFECTS ON DOMESTIC MANUFACTURING

Policy Instruments	Principal Decisionmakers
1. Customs Duties	Department of Finance
2. Import Sales Taxes	Department of Finance
3. Domestic Sales Taxes	Department of Finance
4. MPO (Withholding Tax)	Department of Finance
5. Import Prefinancing Requirements	Bank Indonesia/Department of Finance
6. Prohibition or Quota of Certain Imports/Exports	Department of Trade on Recommendation from Department of Industry or other Relevant Departments
7. Government Monopoly on Certain Products	Cabinet
8. Checkprices:	
Exports	Department of Trade
Imports	Customs Office/Department of Finance in coordination with Department of Industry & Trade
9. Export Taxes	Department of Finance
10. Special Export Taxes	Department of Finance
11. Various Levies on Specific Products (e.g., Timber Exports)	Individual Departments
12. Exchange Rate	Cabinet/Bank Indonesia
13. Special Exchange Rates	Department of Finance
14. Export Certificates:	
Percentages	Department of Finance
Checkprice	Department of Trade
15. Investment Licensing	BKPM (Investment Coordination Board)/ Department of Industry
16. Special Tax/Customs Duties Facilities	Department of Finance on Recommendation from BKPM
17. Preferential Credit Policies	Bank Indonesia/Department of Finance
18. Compulsory Use of Domestic Components by Domestic Industries	Department of Industry, BKPM
19. Compulsory Use of Domestic Products in Gov't. Projects[1]	Cabinet/Minister for the Promotion of the use of Domestically Produced Goods
20. Maximum Wholesale Prices for Certain Imported Goods (Billet/ Ingot, Newsprint, etc.)	Department of Trade
21. Counter Trade Policy	
22. Import Licensing (Tata Niaga Impor)	Department of Trade

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[1] There is an informal rule of thumb that one should use domestic components if the price differential with respect to imports is only 15 percent.

Source: Mari Pangestu and Boediono, "The Structure and Causes of Manufacturing Sector Protection in Indonesia," Draft, undated, but includes some information through 1984.

Table V-2

BASIC INDICATORS: INDONESIA

	Level or Share		Annual Rate of Growth (Based on Constant Price Series)	
	1965	1984	1965-73	1973-84
			Growth of Production	
Gross Domestic Product (Mill US$)	3,630	80,590	8.1	6.8
Share of GDP (%)				
Agriculture	59	26	4.8	3.7
Industry	12	40	13.4	8.3
(Manufacturing)	8	12*	9.0	14.9
Services	29	34	9.6	8.6
Exports of Goods & Non-Factor Services	5	23		
Merchandise Trade			Growth in Trade	
Exports (Mill. US$)		21,888	11.1	1.4
Imports		13,882	14.0	10.5
Structure of Exports (Percentage of Total Exports in Current $)				
	1965	1983		
Fuels, Minerals & Metals	43	80		
Other Primary Commodities	53	12		
Textiles & Clothing	(.)	1		
Machinery & Transport Equip.	3	1		
Other Manufacturing	1	6		

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*Manufacturing share for 1984 is taken from another source and may not be strictly comparable.

Source: World Bank, World Development Report 1986.

In the 1980s, the combination of oil glut and global recession had a dramatic effect on the Indonesian economy. In this adverse environment, Suharto's economic team faced two immediate challenges: first, steering away from the pitfalls that befell other middle-income, oil-exporting countries after 1982; second, revamping the structure of macroeconomic incentives, so that the economy would be in a better position to capitalize on world recovery once it materialized. To deal with declining oil revenues, the government targeted rapid growth in non-oil exports, sharply curtailed imports, expanded borrowing from foreign banks, and drew down its foreign exchange reserves.

Since Indonesia did not want to incur a heavy debt burden (and has not done so), most of its economic adjustment has taken the form of reduced imports. The introduction of austerity budgets was a primary adjustment mechanism; others include: substantial reductions in subsidies for domestic fuel and food consumption, devaluation of the rupiah, a major rephasing of capital-intensive development projects, the removal of controls over lending and borrowing rates in state-owned banks, the abolition of credit ceilings, and a variety of far reaching financial and tax reforms, including a 10 percent value-added tax in January 1984. In 1982, a new package of export promoting measures was introduced, and in 1985 a complete reform of the inefficient and corrupt port system that had been impeding exports was initiated.

Together with these generally more liberal measures, however, came a tightening of controls, including the granting of monopoly powers to individual firms, and a variety of other detailed interventions and controls. Indonesia's nominal and effective rates of protection are still among the highest in South and East Asia. Estimates for the 1970s indicate that effective rates of protection were highest for durable consumer goods and progressively lower for intermediate and capital goods, with wide variations among industries as an unintended result of the ad hoc fashion in which restrictions were imposed. By 1980, the rate on consumer goods had been reduced, those on intermediate and capital goods increased, and the variability among industries narrowed. Nevertheless, although the government has expanded its efforts to promote exports, its industrial and trade policies remain strongly inward-looking. Moreover, despite the major challenge to the government of creating more jobs, protection still appears to promote capital-intensive industry.

B. Role of Subsidies in Indonesia's Economic Policy

Economic policy in Indonesia has always been subordinated to political, security, and social priorities. Indonesia is the largest archipelagic nation in the world, and the country's size and the isolation of many of its islands have contributed to the creation of a highly heterogeneous society characterized by important ethnic, religious, and regional distinctions. As a result, the government has placed great emphasis on forging national consensus and unity. Although economic growth is important to maintaining the regime's legitimacy, national security concerns have always taken precedence. Indeed, economic development is seen to depend on adequate political stability.

Not surprisingly, the focus on national unity has resulted in a series of policies designed both to centralize economic control and to provide sufficient economic resources (by means of large projects, education, improved transportation and communications, the stimulation of plantation enterprises, trahsmigration, and many others)* to reduce sources of political discontent. The policy instruments used to attain these goals have included a variety of direct or indirect subsidies. With the beginning of formal planning in 1969, development and industrial policy goals have been explicitly articulated. REPELITA I (1969/70-1973/74) gave priority to industries ancillary to agriculture and food production and to the rehabilitation and expansion of older import-substitution industries such as textiles. REPELITA II (1974/75-1978/79) shifted priorities toward social objectives, mainly promotion of employment growth and pribumi businesses.** REPELITA III (1979/80-1983/84) explicitly targeted a broad range of industries for support, using the rapidly growing oil revenues, including mainly resource based processing and manufacturing and labor-intensive manufacturing exports. REPELITA IV (1984/85- 1988/87), reflecting the oil price drop, shifted priorities even more strongly toward promoting manufacturing, building on the agricultural and mineral base and on handicrafts and small business, while also pursuing an ambitious program to develop engineering industries (heavy and light machinery and equipment).

Social, regional, political, and development goals sometimes conflicted among themselves for scarce resources. For example, the goal of keeping food prices low and stable conflicted with the imperative of expanding food production. Over time, large subsidies have been required to meet both goals. Moreover, the policy results frequently differed from stated goals. For example, the desire for strong centralized control and the interest in large projects, combined with the inward-looking bias, resulted in the expansion of investments in capital-intensive industries and processes. The investments produced only limited employment growth, in clear conflict with the stated objective of promoting labor-intensive manufacturing. Direct and indirect subsidies have always been part of the policy mix used to achieve specific goals, and their magnitudes have changed as the various objectives and external conditions have changed.

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*Although these efforts have enjoyed government priorities, they have typically been addressed with highly centralized programs that were not particularly sensitive to the great ethnic and regional diversity of the country. Education and agricultural policies in particular have become highly bureaucratized, sharing little if any of real decisionmaking power with local communities.

**The literal interpretation of pribumi is native or indigenous. Overtime, it has become a term used widely in the economic development debate as primbuni firms and nonindigenous businesses (usually comprised of the Dutch or Chinese) contend for their stake in the economy.

Perhaps the major means of dealing with poverty has been the use of selective price controls and subsidies on basic necessities, mainly petroleum products and foodstuffs. (The largest food subsidies were on rice, they took the form of controlling the market price to consumers and support for fertilizer and pesticide production).* These subsidies had become enormous by the early 1980s; they were substantially reduced in early 1982, when domestic prices of petroleum products and rice were raised.

A large variety of incentives, subsidies, and investments (including transmigration) have been used to promote both agriculture and industry on the outer islands. In general, these policies have helped to unify the nation and to reduce political tensions, but they failed to reverse the industrial bias towards Java (and Jakarta), particularly for manufacturing investments.

A major tool of industrial policy (which also served political ends) has been state enterprises. State enterprises now hold strategic positions in almost every sector of economic activity, particularly in industry and banking. Besides some direct budgetary support (especially investment spending), these strategic public enterprises have had access to subsidized credit from the state-controlled financial system.

There has long been serious concern in Indonesia about a perceived Chinese dominance of the economy. After 1974, the government introduced explicit economic nationalism to benefit the _pribumi_. The number and role of state enterprises and agencies were expanded to counterbalance the Chinese influence in private industrial and commercial enterprises. The government provided an array of preferential contracts, credit, and other arrangements for _pribumi_ entrepreneurs, to the disadvantage of ethnic Chinese and foreign businessmen. In particular, the government-controlled financial markets were used to channel funds almost exclusively to state corporations and _pribumi_ enterprises; other firms were forced to borrow from the small, mostly Chinese, private banks and from international financial institutions.

The main means of controlling the private sector and guiding the direction of private investment is through the extensive system of regulatory and administrative controls. Various incentives, tariffs, and financial and foreign investment policies also have been important instruments. Industrialization has always been pursued with multiple objectives; when combined with extensive requirements for licenses and permits and great bureaucratic discretion, the result has tremendous inefficiencies and graft. Although the industrial strategy was designed to have an explicit import-substitution bias, it has induced much stronger capital-intensity, and much greater variability of protection among activities than was expected or intended. While devaluations since 1978, the introduction of an export rebate scheme, and reduced import tariffs and sales taxes for intermediate goods have reduced some aspects of the import-subsidization bias, domestic pressures have simultaneously led to the introduction of restrictions that raise effective rates of protection in some areas.

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*From time to time, the government has attempted to regulate a whole array of prices, particularly following devaluations. Over time, however, the most significant commodities that the government has attempted to control were petroleum products, fertilizers, pesticides, and rice. The government has faced a special problem of how to keep rice prices high enough to maintain incentives for farmers, yet stable and low enough to subsidize consumption. Pesticide and fertilizer subsidies were used to lower the input costs to farmers when world rice prices fell, which helped maintain this difficult balance as green revolution technologies, improved management, and mechanization spread through the countryside. Indirectly, the government strongly influences the prices of many other commodities through state enterprises, even without explicit controls.

Many of the industrial incentives are available only with an approved investment license from the investment coordinating board (BKPM). Investment proposals are evaluated against the investment priority list (DSP), which is revised annually. Import tariff rebates for capital equipment and raw materials, special licenses, and differentiated tax and investment allowances are based on various criteria related to DSP investments. Subsidies have primarily directed resources to _pribumi_ firms, maintained price stability in basic consumption goods, and supported priority industrial sectors, mainly via state-owned companies but also through private firms. The primary instruments are direct government grants and loans and preferential treatment by state-controlled financial institutions, mainly through credit ceilings, interest rate regulations, and rediscount policy.

C. Types of Subsidies*

Indonesia's complex regulatory and licensing system provides many indirect subsidies that are virtually impossible to document or to evaluate. There are, however, explicit programs that provide incentives for priority industries and in some cases for exports. Some of the major incentive programs that may constitute subsidies under GATT and U.S. law are described below.

1. Export Subsidies

- _Import Tariff Rebates:_ Investments included on the annual investment priority list and meet other standards (as determined by BKPM) are permitted rebates on import tariffs, among other incentives. Upon signing the subsidy code, Indonesia agreed to replace the rebate with a drawback scheme that complies with the code.

- _Export Countertrade (Counterpurchase) Program:_ This program, administered by the Indonesian Ministry of Trade, requires foreign suppliers of certain goods and services to purchase for export an amount of goods equal to the value of goods and services provided. Although no financial assistance for the counterpurchase is provided, it may represent an indirect subsidy to exporters.

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*This section draws from the Annex.

- Preferential Short-Term Financing for Non-Oil Exports: Local banks, under a program administered by Bank Indonesia, provides working capital export credits to Indonesian exporters at preferential interest rates. When Indonesia signed the GATT subsidy code in March 1985, it agreed to phase out preferential export credits over a five-year period.

- Free Trade Zone Benefits: Various benefits are provided to commercial ventures established in free trade zones and bonded warehouses. It is claimed by the Indonesian government that these benefits are provided on a commercial basis, with no special financial incentives or tax advantages.

- Import Duty Exemptions for Capital Equipment: Import duties on capital equipment are provided to certain priority industries and in some cases are contingent upon export performance. The latter are clear export subsidies under the subsidy code.

- Access to Inputs at World Market Prices: Firms that export at least 85 percent of production are entitled to buy local raw materials at no higher than import prices in the world market or are permitted to import those materials exempt from trade regulations.

2. Domestic Subsidies

- Preferential Medium- and Long-term Financing: A variety of economic development-oriented institutions and banks provide medium- and long-term financing to domestic companies. Some of this financing is provided at commercial interest rates and under commercial considerations, but the flow of funds is directed by government decree to priority industries and sectors. Other funds are available to *pribumi* firms on preferential terms, while others are so-called second window loans, which represent the intermediation of development funds, from the World Bank and various multilateral and bilateral economic assistance organizations, to domestic organizations.

- Tax Holidays, Accelerated Depreciation, and Various Other Tax Benefits: These are provided to investments that are on the government's priority lists. Since these benefits are not available to all industries, they may meet U.S. legislative specificity requirements that are used to define the existence of a subsidy. Some specific export linked tax benefits were eliminated under the tax legislation introduced in December 1983.

- Incentives for Companies with Publicly-held Stock: Indonesia provides a variety of benefits to stock companies, with the goals of creating an active stock market and promoting the growth of private firms.

- Government Investment: The Indonesian government invests extensively in all sectors of the economy. Some of the state companies require substantial current funding as well, since they do not operate on a commercial basis. Such investment and ongoing support may confer subsidies on the production of these companies.

- Industrial Estates: Indonesia has a variety of operational industrial estates that provide infrastructure and a variety of services that may constitute subsidies.

- Import Duty Exemptions for Capital Equipment: Selected priority industries can receive duty exemptions on imported capital equipment.

- Locally Produced Capital Goods are Exempt from Duties on Imported Materials

- Selected Incentives for Foreign Investments: Various benefits are provided to foreign investors under various conditions. Among them are the exemption or reduction of import duties on equipment, machinery, spare parts, raw materials, and auxiliary goods, as well as the ability to defer paying value-added tax on the importation of capital goods, the exemption from transfer of ownership duties with respect to the initial registration of ships in Indonesia and several others. In addition, foreign firms that locate outside Jakarta in selected areas or that export all (85 percent) production qualify for selected other incentives.

D. Trade Disputes Involving Indonesian Subsidies

Indonesia has faced only one countervailing duty (CVD) investigation (certain textile mill products and apparel) in the United States. The petition was filed in July 1985, and a positive preliminary determination was made in December 1985. The investigation was terminated upon Indonesia's signing of the GATT subsidies code. When the status of the investigation had to change to provide proof of material injury. The preliminary determination found three programs that offered net bounties or grants: 1) preferential short-term financing, 2) tax holidays, accelerated depreciation, and other tax benefits accorded to priority industries, and 3) import duty exemptions for capital equipment afforded priority industries and those that were linked explicitly to export performance. The case summary is shown in Table V-3. The net bounty or grant found was only 0.83 percent ad valorem on textile mill products and 0.636 percent *ad valorem* on apparel.

Interviews with Indonesian officials revealed a great deal of animosity toward the U.S. regarding the use of a CVD case to force them to sign the subsidy code.

Table V-3

INDONESIAN SUBSIDY PROGRAMS: U.S. INVESTIGATIONS

	Number of Times Cited	Number of Times Case Case and/or Program Found C.V.
Total # of Cases	1	1
Programs:		
Textile Export Incentive Program	1	
Export Countertrade Program	1	
Preferential Short-Term Financing for Non-Oil Exports	1	1
Domestic Investment Law	1	
Development Bank of Indonesia	1	
Indonesia Development Finance Corp.	1	
Corporate Tax Ordinance of 1925	1	1
Government Regulation #2/1981	1	
R.T. Danareska Stock Certificates	1	
Tax Reductions Under Decrees #KEP-16771 MK and #112	1	
Government Investment in Fiber Mills	1	
Free Trade Zone	1	
Bonded Warehouses	1	
Industrial Estates	1	
Import Duty Exemptions for Capital Equip.	1	1

Source: United States Department of Commerce--Import Administration--Central Records Information Management System.

E. Impact of Indonesia's Subsidies

Indonesia's subsidy policies cannot clearly be identified as distinct from the complex, highly interventionist role of the government in the economy. In terms of direct subsidies, most have been for development projects, to support prices of certain consumer necessities (largely eliminated in recent budgets, although the fertilizer subsidy continues to be important), to support large-scale state enterprises, to transfer resources to pribumi businesses, and to transfer resources to the outer islands.

Assessments of this broad range of programs are very mixed. There has been a clear improvement in infrastructure and rapid growth of manufacturing value-added. But there has also been excessive centralization, the creation of large-scale and often inefficiently run state enterprises, and the promotion of an excessively capital-intensive, high-cost production structure. Subsidies have played only a small role in the general structure of industrial incentives, compared to the high effective rates of protection afforded by tariffs, licensing, and other import controls (combined with the excessively complex regulatory system). (Protection rates are summarized in Table V-4.)

The early 1980s have seen explicit trends both to liberalize (most notably in the financial system) and to tighten import restraints and controls (primarily in response to the need to cut imports for balance of payments reasons). Still the policy structure remains inward-looking. Export subsidies continue to be used, mainly to offset the impact of import protection on the cost of export products, but the costs of the import bias to exporters have not been fully offset by export incentives, even with recent policy changes. Nontraditional exports have grown over time, largely despite the domestic policy bias.

The main subsidies problem that Indonesia is likely to face in the future results from the fairly explicit industrial targeting that is used. This targeting has caused few problems to date, only because of the limited volume and range of manufactured goods that Indonesian exports to the United States.

Table V-4

INDONESIA: AVERAGE NOMINAL & EFFECTIVE RATES OF PROTECTION, 1975 & 1980

(Percentages)

		Nominal Rates of Protection		Effective Rates of Protection	
		1975	1980	1975	1980
Overall	(1)	48	27	67	33
	(2)	70	33	115	56
Exportables	(1)	41	23	61	29
	(2)	56	27	91	32
Non-Competing Import Sectors	(1)	20	8	17	7
	(2)	20	9	21	9
Import Competing Sectors	(1)	56	32	80	39
	(2)	74	37	121	60

Notes: (1) Simple average; and (2) average with production weights.

The trade classification used is based on import, export and production figures from the 1975 Input-Output tables. The estimates presented here are based on the 1975 production structure and on import duty and sales tax collection dated for 1975 and 1980. Since export taxes and various other policies are excluded, the estimates are only approximations, but are indications of the level and trend.

Source: Mari Pangestu and Boediono, "The Structure and Causes of Manufacturing Sector Protection in Indonesia," Draft, undated, Table 7.

VI. MEXICO[*]

A. Characteristics of Mexico's Economic Policy

Like Brazil, Mexico has followed generally inward-looking economic policies, concentrating on its domestic market, and heavily protecting its domestic producers. Mexico's dependence on foreign trade is greater than Brazil's because of its smaller and less diversified economic base. The Mexican economy is subject to widespread government controls; until 1986, more than two-thirds of imports required a license, and businesses need government authorization for many decisions. Moreover, the government or government enterprises finance over one-half of total investment.

During the 1950s and 1960s, Mexico fostered economic growth through import-substitution policies, by encouraging domestic production of manufactured goods behind high tariffs and quantitative restrictions on imports. Exports consisted mainly of a variety of metals, other minerals, and agricultural products. Exports and imports were heavily taxed; export taxes reached as much as 15 percent of revenues in the mid-1950s, subsequently declining to less than five percent by the late 1960s. Exports were kept profitable, however, by a favorable and generally stable exchange rate. The peso was closely tied to the U.S. dollar through conservative monetary policies and a low rate of inflation.

Mexico benefited dramatically from the global oil boom of the 1970s, which coincided with a rapid expansion of Mexican oil production and export volume. But the resulting surge in export earnings led to the development of severe structural imbalances in the Mexican economy. The share of crude oil in total exports went from zero in 1973 to 69 percent in 1981. These enormous new revenues flowed into the coffers of PEMEX, the Mexican government's oil monopoly, and were spent on government projects. Government expenditures, however, rose even more rapidly than oil revenues and Mexico went heavily into debt, especially to foreign banks. As oil exports first leveled off and then began to decline, the growth of debt accelerated, reaching nearly $100 billion by 1983. The rapid growth of the economy (about 8 percent per year during 1976-80), the massive increase in government spending, and the many resulting production bottlenecks contributed to high inflation and a grossly overvalued peso. As a result, non-oil exports declined and imports increased rapidly--a three-fold increase in real terms between 1979 and 1981--until the debt crisis set in.

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[*] The principal sources used in this chapter are: Maurice Ernst and Jimmy W. Wheeler, The Impact of Industries Country Protectionism on Selected LDCs (HI-3863-RR) (Indianapolis, IN: Hudson Institute, January 1987); United States International Trade Commission, Industrial Targeting and Its Effects on U.S. Industries Phase III (USITC Publication Number 1632) January 1985; and Mexico Manufacturing Sector: Situation, Prospects and Policies (Washington, D.C.: The World Bank, 1979).

Mexico was the first major LDC to face a debt crisis. In 1982, foreign exchange reserves were completely depleted and foreign credit stopped. As part of an arrangement for debt rescheduling and new credits with foreign banks and the International Monetary Fund (IMF), Mexico drastically contracted its domestic demand and devalued its currency. Domestic industrial production fell, not only because of reduced consumer purchasing power and drastic cuts in public investment, but also because foreign exchange was rationed so severely that needed materials and components often could not be imported. Output of machinery and equipment declined over 50 percent and imports 70 percent between 1981 and 1983 (Table VI-1).

The Mexican economic adjustment was so severe that by 1983 the country was running a large enough current account surplus to pay interest on foreign debt amounting to some 40 percent of export earnings. The shift between 1981 and 1983 in the current account balance from deficit to surplus, plus the increase in net interest payments abroad, came to 16 percent of GNP. Mexico's quick adjustment enabled the government to ease domestic credit in 1984 and initiate some recovery of domestic demand. This recovery was cut short, however, by the collapse of world oil prices in 1986. By mid-1986, the Mexican economy was again on the decline. The Mexican government expects that the recent agreement with the IMF will provide enough new bank funding to permit some economic recovery in the latter part of 1987.

During the mid- and late 1970s when the peso was severely overvalued, Mexico's economic policy was strongly biased against exports. According to a 1979 World Bank study, incentives favoring manufactured exports were counterbalanced by various disincentives, including the unfavorable effects of the overvalued peso, resulting in negative net rate of export incentives of 10 percent in 1975.*

The situation changed greatly as a result of the 1982 devaluation and the subsequent float. According to Mexican data from the National Plan for Industrial Development and Foreign Commerce, in 1983 domestic prices for a wide variety of goods were generally below those of similar imported goods, in spite of generally high tariff rates--i.e. the level of both nominal and effective protection was negative for the great majority of industries (Table VI-2). It is quite clear that the de la Madrid administration is giving a very high priority to diversification of Mexican exports away from oil. Non-oil exports in fact have been growing rapidly in recent years (Table VI-3), but continued growth depends primarily on maintaining a competitive exchange rate for the peso.

B. Role of Subsidies in Mexico's Economic Policy

Mexico has used subsidies predominantly to promote domestic economic and social objectives. Some of the principal objectives have been:

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*The World Bank, Mexico--Manufacturing Sector: Situation, Prospects and Policies (Washington, D.C.: World Bank, 1979), p. 20.

Table VI-1

MEXICO: RECENT MACROECONOMIC TRENDS

	1981	1982	1983	1984	1985
1981 = 100					
GDP in Constant Prices	100	99.5	94.2	96.9	n.a.
Industrial Production[a]	100	98.1	90.0	93.4	98.1
Production of Machinery & Equip.[b]	100	80.3	43.3	53.1	70.8
Exports (in Current Dollars)[a]	100	108.0	111.1	124.2	112.5
Imports (in Current Dollars)[a]	100	62.8	34.1	46.8	55.9
As A Percentage of GNP					
Private Consumption	63	64	64		
Government Consumption	10	12	10		
Gross Fixed Investment	27	24	18		
Increase in Stocks	3	-1	3		
Net Factor Payments Abroad	-3	-6	-6		
Imports	14	12	10		
Exports	12	18	21		
Net Imports	-2	6	11		

Notes: a) International Monetary Fund, International Financial Statistics; and b) Instituto Nacional De Estadistica Geografia E Informatica, Cuaderno De Informacion Oportuna, V. 159, Junio De 1986.

Table VI-2

MEXICO: TARIFF PROTECTION AND NOMINAL AND EFFECTIVE RATES OF PROTECTION

Sector	Tariff Level[1]		Level of Protection[2]	
	Average[3]	Weighted[4]	Nominal[5]	Effective[6]
Paper and Cardbord	31.6	7.1	-13	-6
Printing and Editorial	33.9	2.8	-40	-56
Petroleum and Derivatives	9.6	0.9	-43	-452
Basic Petrochemicals	12.3	2.1	-50	-22
Basic Chemicals	22.2	9.0	- 2	73
Manure and Fertilizers	3.6	0.2	-56	-88
Synthetic Resins and Artificial Fibers	23.0	12.8	25	259
Medicinal Products	14.7	8.5	-40	-61
Soap Detergents	66.3	99.9	-20	-22
Other Industrial Chemicals	17.0	9.7	2	13
Rubber Products	28.8	7.9	28	55
Plastic Articles	35.9	22.8	34	196
Glass	37.4	28.6	-32	-40
Cement	8.3	5.0	-28	17
Other Nommetalic Mineral Products	38.1	28.5	-23	-20
Basic Iron & Steel Ind.	12.8	14.7	-26	-28
Nonferrous Metal Industies	18.3	5.5	11	53
Metal Furniture	45.9	72.6	-22	-35
Structural Metal Products	30.6	44.1	-12	-9
Other Metal Products	37.4	23.5	-17	-23
Nonelectric Machinery	16.8	10.9	3	12
Electric Machinery	20.3	14.7	1	5
Domestic Appliances	67.9	50.2	-9	-12
Electronic Equipment	24.3	18.3	38	125
Other Electronic Equip.	21.2	13.9	10	27
Automotive Vehicles	44.3	59.5	4	87
Automotive Frames & Auto	28.6	8.7	-29	-39
Other Transport Equip.	27.1	7.6	-10	-14
Other Manufactures	29.1	15.1	- 1	9

Notes: 1) Based on imports from January through August 1983; 2) Calculated through September 1983; 3) Average tariff is the sum of the tariff rates divided by the number of fractions; 4) Average tariff weighted by imports is the estimated amount of duties collected divided into value imported by sector; 5) The percentage difference between internal and external product price; and 6) The protection of a product according to inputs in terms of value added.

Source: National Plan for Industrial Development and Foreign Commerce, 1984-88.

Table VI-3

MEXICO: FOREIGN TRADE TRENDS
(Million U.S. Dollars)

	1973	1977	1981	1983	1985
Exports	2,072	4,183	19,420	22,312	21,866
Imports	3,816	5,596	25,053	9,006	14,014
Trade Balance	-1,744	-1,413	-5,634	+13,306	+7,852
Major Exports					
Oil and Gas	--	990	13,827	15,143	13,309
Agricultural Products	1,050	1,450	1,481	1,188	1,322
Manufactures	894	1,555	3,427	5,448	6,721
Percentages of Total Exports					
Oil and Gas	--	24	75	68	61
Agricultural Products	51	35	8	5	6
Manufactures	43	37	18	24	31

Source: Banco de Mexico: Comercio Exterior de Mexico, Nr. 2, 1986.

- To promote development of certain priority industries, such as machinery and electrical equipment.

- To promote decentralization of industry to relatively undeveloped areas, especially away from Mexico City.

- To enable some relatively inefficient government-owned enterprises, such as steel plants, to compete with lower-cost private enterprises and with imports.

- To support the purchasing power of the urban poor by keeping down the prices of necessities, such as beans and subway fares in Mexico City.

- To promote agricultural and rural development.

Several of Mexico's domestic subsidy programs have at least incidental implications for Mexican exports because they discriminate among industries and regions. In recent years, these programs have become a source of trade difficulties with the United States.

Most Mexican export subsidies are designed mainly to offset or compensate for indirect taxes and import duties and are therefore allowable under GATT and U.S. law. As the peso appreciated in the course of the 1970s, however, some export subsidies also were provided to compensate for the overvaluation of the peso, and were more difficult to justify.

C. Types of Subsidies*

Mexico has used a variety of instruments to promote exports, many of them not considered allowable under U.S. law. The number increased greatly during the 1970s when the peso was overvalued, but it was not a major problem then because Mexican exports of manufactures to the U.S. were small. It became a problem during the 1980s as a result of Mexican efforts quickly to diversify exports away from oil, coupled with Mexico's refusal to join GATT, a policy that continued until 1986. The principal Mexican subsidies are described in detail in the annex to this chapter; they are of the following types:

1. Export Subsidies

With regards to specifically export-oriented subsidies, the main programs have been:

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*In addition to the sources cited earlier, the main sources used in the preparation of this section are the publciations of the monitoring system of the U.S. Trade Representative and the testimony and findings of CVD cases in the U.S. Federal Register.

- Export financing at below-market rates, mainly through the Fondo para el Fomento de las Exportaciones de Productos Manufacturados (FOMEX) program. This has probably been the most important export subsidy in recent years.

- Tax rebates on exports for taxes paid on items incorporated into the final product. The rebates were generally paid under the Certificado de Devolucion de Impuestos (CEDI) program, which was suspended in August 1982, and were often found to be in excess of the indirect taxes paid. Many were considered countervailable.

- Several programs provide loans below market interest rates to finance capital investment and imported inputs for manufacturers of exports.

- Exemption from taxes and import duties, including duties on imported machinery and equipment for firms producing in export zones.

- Provision of a variety of trade services by government enterprises such as the Mexican Institute of Foreign Trade (INCE), which organizes and funds trade missions and other marketing services. It also reimburses a substantial part of the export-promotion cost of private firms, covers the cost of export credit insurance, and provides open licensing for imports used by established trading companies.

2. Domestic Subsidies

The principal domestic subsidy programs are:

- A variety of tax credit certificates to companies that satisfy criteria for promoting economic development in priority regions or activities, and for meeting more general industrial development goals. These certificates (CEPROFIs) are issued for the first five years of a new investment and can be used to pay any type of federal tax. Although they are not specifically designed to promote exports, the fact that they are regionally and sectorally selective rather than available to all firms, has made them subject to U.S. countervailing duty litigation in some cases.

- Several programs to finance industrial development at below-market interest rates are used mainly to promote import-substitution and a small amount of export-promotion (FONEI), to promote development of small and medium-scale enterprises in selected manufacturing industries (FOGIN), and to aid in industrial decentralization (FIDEIN). In some cases, the U.S. has found some of these programs to be countervailable because of their selectivity.

- Preferential prices for natural gas, oil, and electric power. While Mexico has held domestic prices of oil and gas generally well below world market prices (although the gap has been narrowing), additional price discounts of 30 percent on the cost of industrial energy or basic petrochemical products have been given to firms in priority regions, such as the north, and to priority industries, such as cement, ceramic tile, and ammonia. Special rebates were also given on railroad freight and shipping costs. The main purpose of these rebates has been to make industries in certain border regions competitive with imported goods in spite of high transportation costs and remoteness from sources of energy. The selectivity of these rebates has made them sources of trade disputes with the U.S.

- Below-market credit for agricultural development under a variety of programs. These credits have not been a source of trade disputes.

- Large subsidies are given to public transportation, especially the Mexico City subway system, and to producers of basic food products, particularly corn and beans, wheat, rice, sorghum, and oil seeds, to keep the prices of these necessities at very low levels. These subsidies have been a heavy burden on the Mexican budget, but have not been a source of foreign trade difficulties.

D. Trade Disputes Involving Mexican Subsidies

The history of trade disputes involving Mexican subsidies was recent, brief, and intense. These disputes have been almost exclusively between Mexico and the United States, which is the market for some 60 percent of Mexico's total exports and even larger shares of Mexican exports of manufactures. Indeed, for many manufactured goods, such as steel and cement, the U.S. has been virtually the only export outlet for Mexico.

The surge of trade disputes in recent years has been due partly to Mexican attempts rapidly to expand exports of manufactures. Although Mexico's main adjustment to its balance of payment problems during 1982-84 was to cut imports, exports also increased somewhat, despite a weak market for oil and metals. While exports of oils and most other minerals declined because of falling prices, exports of manufactures doubled. During 1982-86, particularly rapid growth was achieved for exports of textiles (80 percent), chemicals (70 percent), steel (340 percent), automobile engines (400 percent), cement (600 percent), and glass (100 percent). Nearly all of these exports went to the United States.

The first U.S. countervailing duty cases against Mexico were initiated during the 1970s (carbon steel plate, asparagus, and certain textile products). Although many potentially countervailable Mexican programs were identified, no duties were actually imposed because the program's benefits were found to be de minimus or the volume of trade negligible (Table VI-4 summarizes the programs). Moreover, according to some well-informed

Table VI-4

MEXICO: U.S. DEPARTMENT OF COMMERCE INVESTIGATIONS OF SUBSIDY PROGRAMS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Total # of Cases	27	24
Programs:		
Article 94	11	2
Accelerated Depreciation Allowance	10	2
BANCOMEXT	4	1
CEDI	18	2
CEPROFI	23	14
COMEXEC	7	
Discounts or Rebates for Electricity	11	2
Dual Level Currency Exchange	7	
FICORCA	2	
FIDEIN	12	
FIRA	2	
FOGAIN	19	7
FOMEX	21	18
FOMIN	16	
FONEI	20	8
FONEP	11	
Inbond Assembly Program	3	
Government Financial Technological Develop.	7	
Government Financial Housing	2	

Table VI-4 (Continued)

MEXICO: U.S. DEPARTMENT OF COMMERCE
INVESTIGATIONS OF SUBSIDY PROGRAMS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Programs:		
Government Financial Industrial Promotion	1	1
IMCE	11	
Import Duty Reductions on Inputs	19	2
Income Reduction	1	
NIDP Preferential Discounts	4	
Port Facilities	4	
Preferential Pricing of Basic Petrochemical Products	3	
Preferential State Investment	7	
Preferential State Tax Incentive	8	
Preferential Vessel, Freight, Terminal, and Insurance Benefits	10	
SAM	1	
NAFINSA	5	1
VAT Reduction	1	
Industry Specific Incentives	2	
National Financiera	2	1
PROFIDE	3	

Source: Documentation on subsidy cases obtained from the United States Department of Commerce's Central Records Information Management System.

observers*, the U.S. government appears to have given Mexico the benefit of the doubt because of the importance it places upon bilateral relations with Mexico, especially in the hope that Mexico would accept the GATT subsidy code during the Tokyo Round of negotiations in 1979.

But Mexico rejected the Tokyo Round and for domestic political reasons, decided not to join GATT, thereby exempting it from the benefits of the 1979 U.S. Trade Agreement Act. (The Act incorporates an injury test on countervailing duty cases involving GATT subsidy code members and certain countries with which the U.S. has agreements that embody obligations substantially equivalent to the GATT code.) The more explicit criteria for defining unfair LDC subsidies under GATT, the tougher U.S. code under the 1979 Trade Agreement Act, the exclusion of Mexico from an injury test, and the surge in Mexican exports of manufactured goods to the United States combined to bring about a very large number of countervailing duty cases in the United States against Mexican goods. New CVD cases were brought against two products in 1981, another six in 1982, seven more in 1983, seven in 1984, and three in 1985. By 1984, the U.S. had levied countervailing duties on nine types of Mexican products. In 1985, countervailing duties on a wide variety of steel products were suspended as part of the voluntary export restraint agreement for Mexican steel.

Since 1984 trade disputes have lessened as a result of a major shift in Mexican economic policy. A political consensus was achieved favoring rapid export-diversification and a degree of import-liberalization. This shift occurred largely because of a growing realization that oil prices were likely to remain low for a number of years, and that oil exports could not be counted on to sustain the Mexican economy.

Mexico subsequently negotiated a bilateral understanding with the U.S. in 1985 as well as a program for accession to GATT. The bilateral understanding included the elimination or phasing out of a number of subsidy programs. This enabled the U.S. to treat Mexico as other signatories of the subsidy code in countervailing duty cases--namely, to require an injury test. Although major issues remain, notably whether or not the injury test requirement should be made retroactive, there was a precipitous decline in the number of countervailing duty cases against Mexico during 1985, and none were filed in 1986.

E. Impact of Mexican Subsidies

As is also true for Brazil, Mexican subsidies are both a cause and a consequence of the widespread price distortions in the Mexican economy. They are a consequence to the extent that subsidies are used to offset the intended or unintended effects of import duties and controls on the cost of Mexican exports. They are a cause to the extent that subsidies create price disparities among industries, regions and final products. During the 1950s and 1960s, Mexico was able to achieve fairly rapid and stable economic growth rates (5 to 6 percent), despite the prevalence of government controls and the emphasis on import substitution, because it followed generally conservative fiscal and monetary policies.

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*Andrew James Samet and Gary Claude Hufbauer, Unfair Trade Practices: A Mexican/American Drama, Overseas Development Council, U.S.-Mexico project, April 1982.

Price distortions increased greatly in the 1970s, as a result of the oil boom and the resulting surge in government expenditures. Both the increased government role and the growing price distortions enhanced the role of subsidies. Nonetheless, an overvalued peso limited the growth of exports of manufactures, despite widespread subsidies.

After the 1982 devaluation of the peso, subsidies continued to contribute, at least in a small way, to the rapid growth of exports of manufactured goods. Since 1985, the value of the peso has probably fallen enough to make a fairly wide range of industrial exports profitable without subsidies.

The impact of subsidies on economic growth cannot be distinguished from all of the other factors that affect performance, but to the extent that they are used to compensate for the negative consequences of other poorly designed policies and consequently to help sustain these policies, subsidies have almost certainly retarded Mexico's economic growth and industrial progress.

The adverse impact of U.S. actions against Mexican products has been appreciable, because of both the countervailing duties imposed and the uncertainties inherent in the litigation process. Mexico suffered substantial losses even from the voluntary restraint arrangement on steel because few alternative markets are available, and domestic demand has been depressed.

VII. HONG KONG*

A. Characteristics of Hong Kong's Economic Policies

Hong Kong was founded in 1842 as a base for British trade with China and served primarily as an entrepot port for that trade until the communist revolution. A variety of small-scale and some larger modern manufacturing firms were established after about 1880, with shipbuilding and parts and equipment for ship repair services being the largest sector. Hong Kong's modern history, however, begins in the immediate postwar period, when the entrepot trade with China ended. At that time, there was a large influx of skilled workers and managers and a substantial inflow of capital, all fleeing the Peoples' Republic of China (PRC). Combined with the stable British administration, the commitment to largely laissez faire economic policies and an entrepreneurial, commercially-oriented business culture, these human and capital resources found a fertile ground in which to develop. The 1950s can be viewed as a period of consolidation and restructuring as the city-state adapted to this huge influx and as new activities and trading relations were established to replace the China trade.

Hong Kong's economic progress has been remarkable by any standards (See Table VII-1). There have been two major structural changes in the Hong Kong economy since the 1950s, and a third may be under way. The first occurred during the 1960s, with a dramatic shift of resources into the manufacturing sector. The second began in the early 1970s, with the shift toward the development of Hong Kong as a regional financial center, although manufacturing remained very important. The third shift seems currently underway, with Hong Kong moving toward more skill-, capital-, and technology-intensive manufacturing and services. These shifts are characteristic of economic trends, not necessarily of changes in government strategy.

The Hong Kong government has followed a largely passive strategy toward industrialization, although certain industry-targeted policies were initiated. The government provided a stable regulatory environment and exhibited conservative fiscal management; it has invested heavily in certain infrastructure and public and social services. Since the early 1980s, with the

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*This chapter draws mainly on: David Lethbridge (ed.), The Business Environment in Hong Kong (Hong Kong, Oxford University Press, 1984); Doing Business in Hong Kong (Price Waterhouse, April 1983); Banking in Hong Kong (Peat, Marwick, Mitchell & Co., October 1983); W.A. Reynolds, Factors which Hinder or Help Productivity Improvement: Country Report--Hong Kong (Tokyo: Asian Productivity Organization, 1980); A.J. Youngson, Hong Kong Economic Growth and Policy (Hong Kong: Oxford University Press, 1982); "Financial Times Survey, Hong Kong," Financial Times, (Wednesday, July 3, 1985), Section III; U.S. Department of Commerce, Foreign Economic Trends and Their Implications for the United States: Hong Kong, semi-annual series, various issues; "Survey Hong Kong," The Economist (May 11, 1985); and Business International Corporation, IL & T Hong Kong (August 1984).

Table VII-1

HONG KONG: PRINCIPAL ECONOMIC INDICATORS

Average Annual Rate of Growth	1965-67	1973-84
Inflation	6.4	9.8
Real GDP	7.9	9.1

Structure of Production (%)	1965	1984
Agriculture	2	1
Industry	40	22
Services	58	78

Structure of Merchandise Exports (%)	1965	1983
Fuels, Minerals and Metals	2	2
Other Primary Commodities	11	6
Textiles and Clothing	43	33
Machinery and Equipment	6	22
Other Manufactures	37	36

Sources: International Financial Statistics Yearbook 1986 (Washington, D.C.: International Monetary Fund, 1986); and World Development Report 1986 (Washington, D.C.: International Bank for Reconstruction and Development, 1986).

global economic difficulties and the negotiation of Hong Kong's return to PRC rule in 1997, the Hong Kong government has taken on a somewhat greater role in influencing the economy.

B. Role of Subsidies in Hong Kong's Economic Policy

At the macroeconomic level, the government has pursued laissez faire policies, and conservative fiscal management. There are no foreign exchange controls, virtually no foreign trade restrictions, and no central banking system. (There have been some efforts at monetary control, via the interest rate policies of the Hong Kong Association of Banks. The government's attitude towards macroeconomic control changed somewhat in response to financial problems in the late 1970s and early 1980s. Bank failures led to selected direct interventions and improved regulation. More conservative budgets have been introduced; there have been attempts to restrict the growth of domestic money supply; since 1983, the exchange rate has been pegged to the U.S. dollar through a special arrangement with the two private note-issuing banks.

At the microeconomic level, there is very little government intervention of the sort found in most other countries. There are no minimum wage laws, special loan programs, or special tax concessions to promote selected economic activities. Virtually no special incentive structures are established through regulations and subsidies. Direct ownership of industrial activities is restricted to a few basic services, such as postal, water supply, and airport services. Even the government rail transport systems are organized as public corporations, with the government the sole owner (the Mass Transit Railway and the Kowloon-Canton Railway). Education has been a high priority goal and is largely financed by government, as is the extensive provision of health facilities. Rice prices are stabilized with buffer stocks. All other basic services are provided by private enterprise.

The government has intervened heavily in the land market. Most of the land in Hong Kong is Crown land, it is usually sold by public auction to assure that, in general, land goes to the most efficient uses. There has also been a tendency for the government to try to stabilize land prices by selling land when the price is high and withholding land from the market when the price is low.

Important consumer subsidies have been based on the government's control of land. Some residential rents have long been controlled and are only slowly becoming decontrolled. Another important consumer subsidy has been the provision of housing, especially for low-income families. For a long time, a large part of the government budget has gone to the provision of housing.

Occasionally, the government has assisted specific industries by designating tracts of land to be used only for special purposes and selling them by private treaty rather than through public auction. In effect, this provides land at below market prices. The government also occasionally provides better terms of payment for industrial land than for other uses. For example, incentives have been provided to certain capital-intensive and technology-intensive industries locating in Tai Po, Yuen Long, and on Tsing Yi Island, primarily as part of the government's recent industrial diversification efforts. Special industrial estates have also been established.

Other microeconomic interventions are somewhat more indirect. There is close regulation of the privately-owned public utilities. The Textile Advisory Committee plays an important part in the development of the textile industry, as does government-established marketing organizations for vegetables and fish. On occasion, the government has also participated in selected large projects, such as the development of the shipping container facilities at Kwai Chung and the cross-harbor tunnel. In general, however, the government until recently has adhered to a nonintervention policy for manufacturing industries.

In the past few years, there have been specific attempts to diversify Hong Kong's industrial base. First, the government is improving the regulation and stability of the domestic financial system, in order to keep foreign financial firms in Hong Kong and to attract more of them. Second, the government has taken steps to provide land cheaply for industrial estates. Third, the authorities have expanded industrial training and technology support to help local firms diversify into higher technology and alternative products. Finally, Hong Kong has explicitly expanded its export-promotion and foreign investment-promotion activities.

C. Types of Subsidies*

Hong Kong uses very few explicit subsidies. Although one or two of those used could potentially run afoul of U.S. countervailing duty legislation, most are domestically focused and do not meet the specificity requirements of U.S. legislation. Hong Kong is a full member of the GATT subsidies code through its status as a British Crown Colony.

1. Export Subsidies

No explicit export incentives have been identified and only two programs would possibly qualify:

- The government-sponsored Hong Kong Export Credit Insurance Corporation provides export insurance, but as far as can be ascertained, at commercial rates.
- One criterion for location in industrial estates is the production of exportable products. This is not a requirement, but only one of the evaluation criteria, and seems to be broadly available to all industries.

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*More detail is provided in the Annex.

2. Domestic Subsidies

- The government provides or controls in one fashion or another most public transport facilities, although, except for the railways, the private sector provides the services.

- The Hong Kong government provides substantial support for health facilities, but medicine is not socialized.

- The government also supports virtually all primary education and most secondary and advanced education. Primary education is free, but individuals must pay part of the costs at secondary and university levels, although both are heavily subsidized.

- The government has intervened heavily to control rice prices. In particular, it uses buffer stocks to stabilize short-term price fluctuations. There does not appear to be an effort to provide a long-term subsidy to food consumption.

- The government has provided major housing subsidies through its control over land, construction of public housing, and rent control policies.

- The government's industrial land policy is sometimes used as an incentive for investors in sectors that are regarded as particularly desirable. These actions could constitute a subsidy, since preferential treatment is granted. Exports are one of the criteria used for project evaluation, and the government is particularly interested in promoting certain industries.*

- One part of the government's land policy has been the establishment of industrial estates, which may provide concessional terms to selected preferred industries and thus meet specificity requirements.

D. Trade Disputes Involving Hong Kong Subsidies

The U.S. has filed no subsidy/countervailing duty cases against Hong Kong. Moreover, Hong Kong is a full signatory of the GATT subsidies code through its Crown Colony status.

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*Preference is given to applications for ventures that meet the following standards: it will be new or will manufacture new products; it will involve a higher level of technology than the colony's existing standard; it will provide employment to highly-skilled, technically-trained personnel; it will produce for sale on a local market items required by an existing industry; it will manufacture many exportable products; it will produce goods with a high value-added from local content; or it will produce items of better quality and at a higher rate of productivity than those already available.

E. Impact of Hong Kong's Subsidies

The minimal use of subsidies in Hong Kong is a reflection of the colony's free market and noninterventionist policies. These policies have achieved outstanding results, which include not only rapid economic growth, but also reception of large waves of immigrants without severe unemployment or serious social tension.

VIII. SOUTH KOREA*

A. Characteristics of South Korea's Economic Policy

South Korea has become a textbook case of a successful, outwardly-oriented developing country (Table VIII-1 provides economic indicators). This success is based on many factors, not the least of which is the degree of commitment to economic progress displayed by the government. The South Korean government sees itself as facing an overwhelming national security threat from communist North Korea. Given the magnitude of the external threat, the economic burden of supporting a large military establishment and the need to demonstrate both to its domestic population and to the population of the North that it is the legitimate ruler of all Koreans, the South Korean government has chosen to pursue rapid economic development as it primary national imperative. Its goals have been to develop a strong economic base to support a large military force, to help dissuade the North from adventurism, and to embarrass the communist leadership in the North by outperforming them economically.

By its own standards and by world standards, South Korea has been very successful, even as it remains a developing country with a per capita income of only about US $2,000. The external environment has been favorable for

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*This chapter draws heavily on a variety of sources, the most important is Adrienne A. Kearney and Perry L. Wood, "South Korea: The Politicization of Trade Policy," HI-3836-P (Indianapolis, IN: Hudson Institute, 1986), a background paper prepared jointly for this project and for a project on Trade Policy Formulation in Selected Developing Countries by J.W. Wheeler and Perry L. Wood. HI-3833-P (Indianapolis, IN: Hudson Institute, 1986). See also: Larry E. Westphal and Kwang Suk Kim, "Korea," chapter 8 in Bella Balassa and Associates, Development Strategies in Semi-Industrial Economies (Baltimore and Washington, D.C.: The World Bank by Johns Hopkins University Press, 1982); Lawrence J. Lau, (ed.), Models of Development: A Comparative Study of Economic Growth in South Korea and Taiwan (San Francisco, CA: ICS Press, 1986); Parvez Hasan and D.C. Rao, (coordinating authors), Korea: Policy Issues for Long-term Development (Washington, D.C.: The World Bank by the Johns Hopkins University Press, 1979); World Bank, Korea: Development in a Global Context (Washington, D.C.: The World Bank, 1984); Young Whee Rhee, Bruce Ross-Larson, and Garry Pursell, Korea's Competitive Edge: Managing the Entry into World Markets (Washington, D.C.: The World Bank by Johns Hopkins University Press, 1984); and 1984 Joint Conference on the Industrial Policies of the Republic of China and the Republic of Korea, Conference Series No. 4 (Chung-Hua Institutions for Economic Research, Taipei, Taiwan, December 27-28, 1984); and Industrial Policies of the Republic of Korea and the Republic of China, papers and discussions from the Joint KDI/CHIER Conference, Conference Series 86-01 (Korea Development Institute, Seoul, Korea, November 21-22, 1985).

Table VIII-1

SOUTH KOREA: PRINCIPAL ECONOMIC INDICATORS
(Percentages)

Average Annual Rates of Growth	1953-1961	1962-1972	1973-1979	1980-1984
Real GDP Growth	4.1	9.2	9.8	7.5
Inflation (GDP Deflator)	20.2	16.5	21.2	11.0
Industrial Production	14.2[a]	17.1	23.5	7.5[b]

Exports and Imports as a Percentage of GDP

	1953	1961	1973	1981	1984
Exports	2.1	5.5	29.1	36.0	37.5
Imports	9.9	16.8	32.1	41.3	37.2

Notes: a) 1955-1961; b) 1980-1984.

Source: International Monetary Fund, International Financial Statistics Yearbook, 1979 and 1984; Korea Development Institute, Main Indicators of Korean Economy, 1985.1.18.

South Korea's remarkable economic progress since the 1950s, but domestic policy initiated and supported that growth. The mechanisms used by the government included tax benefits, domestic market protection, allocations of often-subsidized credit, the establishment of state enterprises, direct political influence, and a variety of other inducements. This extensive intervention, however, has always been constrained by a commitment to create internationally-competitive firms. Bureaucratic and other interests have always had to yield, when necessary, to assure continued economic success.

The very aggressive South Korean approach has led to considerable risk-taking. For example, the government established a highly modern, very large steel mill against international advice--a risk that paid off well, despite the currently depressed world steel market. This willingness to take risks can also be seen in South Korea's attempt to ride through the impact of the 1973 oil shock by increasing bank borrowing rather than cutting domestic expenditures. Risk-taking, however, has also contributed to the accumulation of a variety of problems, most notably a large foreign debt burden and an uncomfortably high inflation rate.

Economic policymaking has gone through three broad stages since the conclusion of the Korean War. In the immediate aftermath of the war (1953-1961), the primary concerns were to reconstruct the war-torn economy and to establish political stability. Not surprisingly, and probably correctly, economic policy was inward-looking. Although economic progress was unimpressive by subsequent standards, important gains were made most notably in land reform and agricultural development.

After Park Chung Hee came to power in 1961, the country's resources were directed toward industrialization through an export-oriented strategy. Although key economic decisions were made or strongly influenced by the government, free enterprise was the main engine of economic growth. Government policy was designed to enhance the conditions under which firms could grow and prosper on their own.

There were two policy phases during the Park era: in the first, from 1962 to 1972, the government focused on the rapid modernization of agriculture and on managing the transition from import-substitution industrialization toward industrialization based on a broad balance between export and domestic markets. The result was extraordinary growth of labor-intensive industries, primarily light manufactured goods, which took advantage of a well-skilled, low-wage labor force. Economic growth rates more than doubled, with exports as a share of GDP rising from 5.5 percent in 1962 to 29.1 percent by 1973, while inflation, although high, showed a declining trend.

The second expansionary phase under President Park, from 1973 to 1979, was characterized by a diversification into heavy industrial production. While this was a natural evolution of the economic development process for South Korea, government initiatives accelerated this move in response to the first oil shock, growing protectionism in industrial country markets for textiles and shoes (at that time South Korea's main export products), and the desire to develop a major arms industry in order to become less dependent on the United States for military goods. The government initiated investments in steel, shipbuilding, industrial electronic equipment, petrochemical, and machinery industries.* During this second expansionary phase of the Park regime, the GDP growth rate rose to 9.8 percent, and the so-called strategic industries grew from 37.8 percent of manufacturing output in 1972 to 57.6 percent in 1979 and became a major source of export earnings.

While this industrialization effort was extremely successful, it left the country with significant political and economic "growing pains." Expansion of heavy industry during the 1970s was much too rapid and concentrated. While South Korea leapfrogged over most other developing countries in building modern heavy industries, the concentration of this effort into a very few enormous plants--for example, the Hyundai shipyard is the second largest in the world in gross tonnage capacity--made it vulnerable to shifts in international demand. The high efficiency of these large plants was based in part on economies of scale; production to capacity depended on exports. So long as world markets were strong, South Korea was able to produce at reasonably efficient levels; when world markets became weak, South Koreans were particularly vulnerable. The heavy industry buildup of the 1970s also contributed to overheating the economy. The large investments combined with a government effort to improve living standards by allowing wages to surge, led to the currency becoming overvalued and substantial emerging inflation--which rose to over 20 percent. A variety of serious imbalances in the industrial structure also emerged.

These economic imbalances were intensified by political and economic shocks. President Park Chung Hee was assassinated in 1979, and a coup, carried out shortly thereafter, led to the establishment of a new government under President Chun Doo Hwan in 1980. The new political uncertainties were compounded by major economic shocks: bad weather reduced rice production and necessitated a large increase in imports; the second oil shock approximately doubled South Korea's oil import bill; a sharp recession in the major industrial countries reduced demand for South Korean exports; and real (inflation adjusted) interest rates on the South Korean foreign debt rose markedly. South Korea fell into a sharp recession, during which the current account deficit, foreign debt, and inflation all increased substantially.

The recession was short-lived. Following the rapid return of political stability policies were quickly adjusted. These adjustments included a devaluation of the won, a decision to ease off on the heavy industrial buildup, and a selective liberalization of economic activity. President Chun explicitly espoused a shift in South Korea's economic policies towards a more market-oriented strategy.* Since 1980, the liberalization of foreign trade has been accelerated and the country has been slowly opened to greater foreign investment. The return of more vigorous economic growth and the achievement of current account surpluses since 1985 suggest that this shift in strategy has been successful.

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*These industries were modern and highly efficient, using state-of-the-art equipment, effective management techniques, and a well-trained and disciplined labor force. Japan was the largest source of the technology and has remained the major source of capital goods imports for these industries.

B. Role of Subsidies in South Korea's Economic Policy

Subsidies have been used in a variety of ways to support economic strategy, but have always been only part of a complex array of policies.

The major consumer subsidies have been designed to increase rural incomes, while hold down urban rice costs.** The government has imposed price and share requirements on crop sales (especially rice) to the government Grain Management Fund, subsidized fertilizer sales through the Fertilizer Fund, and used imports to meet urban demand for grains (especially rice) at below-market levels. Parity ratios between rural incomes and costs and between rural and urban incomes have changed over time, but have trended downward since the mid-1970s. A goal of the Chun government has been to improve rural incomes, in part because the rural sector is an important source of his political support. But, the president must also deal with the growing contribution of grain and fertilizer subsidies to the government deficit.

Most other subsidies have been used as adjuncts to the overall industrial strategy. The main production subsidies have been indirect reflections of sheltered domestic markets and the array of special benefits given to large firms. Selected industries have also been provided with direct factor and input subsidies. The principal industrial policy mechanism used by the South Korean government has been credit management. Demand for investment funds has always exceeded the supply available at official interest rates. Targeted industries not only received preferential access but often preferential interest rates--together an effective capital subsidy, which was added to by various tax measures.***

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*See for example, President Chun's 1982 State of the Union address, which stated: "institutional reforms will be continued to strengthen the functioning of the market mechanism." Cited in Bohn-Young Koo, "A Review of the Industrial Incentive System in Korea," (Seoul: U.S. Embassy, 1984), p. 4.

**In South Korea, unlike most developing countries, primary production, particularly agriculture, has received higher effective protection than manufacturing. Moreover, the South Korean tax system has levied no direct taxes on farmers and only low taxes on mining.

***Various other factor and input subsidies existed but were less important. There is some ambiguity with classifying these subsidies since the eligible industries were often picked because of their export potential or their upstream importance to other export industries.

The most important form of explicit industrial policy subsidies were those targeted on exports. These included preferential short-, medium- and long-term credit, rebates of tariffs and indirect taxes on imported inputs and capital goods used in the production of exports, various business tax reductions, and a variety of other special programs.

The principal policy instruments to stimulate industrial development were introduced during the mid-1960s and remained largely unchanged through 1973. By the late 1960s, an incentive system had evolved that generally favored exports over import-substitution. The value of the incentives was quite substantial, accounting for some 30 percent of the value of total merchandise exports in 1968. About 14 percent were due to the tariff exemptions, seven percent to indirect tax exemptions, and four and one-half percent to interest subsidies, the rest being distributed among the wastage allowance, overhead rate reductions, and direct tax reductions.* Primary exports received a substantial negative net effective subsidy. For manufacturing exports, subsidies on average were just sufficient to offset the recurring modest overvaluation of the won (largely due to the protection of domestic markets), so that the net effective subsidy rate was close to zero. For manufacturing as a whole, exports were favored over domestic sales, largely because domestic sales were heavily taxed, while the opposite was true of primary products.

The most important industrial policy changes after 1973, when the currency underwent a substantial devaluation, were the shifts toward selective import-substitution in producer goods, consumer durables, and automobiles, combined with the reduction or elimination of some specific export-promotion programs and continued slow import liberalization in some areas. The strong desire to achieve competitive export industries had led to discrimination against purchases of domestically-produced machinery and equipment. This problem was recognized early in the 1970s, and the government began to reduce the bias. For example, the automatic tariff exemptions for exporters on their capital goods imports were abolished, and a relatively large fund was created to provide medium-term credit at interest rates near world market levels for domestically oriented producers. Nevertheless, the import-substitution policies followed were selective and changed continuously over time as infants grew up, while the system as a whole remained biased toward export promotion. Estimates of effective rates of protection are generally modest, although less, even across industrial sectors, than its major competitor, Taiwan. By the mid- to late 1970s, estimates clearly showed the selective import-substitution policies (Table VIII-2), although these have since been moderated.**

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*Larry E. Westfall and Kwan Sub Kim, "Korea," Chapter 8 in Bella Balassa & Associates, Development Strategies in Semi-Industrialized Economies (Washington, D.C.: World Bank by Johns Hopkins University Press, 1982), p. 217.

**See estimates of effective protection and subsidy rates for the late 1970s in Chong Hyun Nam, "Trade, Industrial Policies, and the Structure of Protection in Korea," in Wontack Hong and Lawrence B. Krause, eds., Trade and Growth of the Advanced Developing Countries in the Pacific Basin (Seoul, Korea: Korea Development Institute, 1981), pp. 187-211, as reported in Paul W. Kuznets, "Government and Economic Strategy in Contemporary South Korea," Pacific Affairs, Vol. 58, No. 1 (Spring 1985), p. 57.

Table VIII-2

PROTECTION IN SOUTH KOREA

Name of Sector (I-O Code)		NPR	EPR
Agriculture, Forestry & Fishing			
Polished Rice(1)		159.7	217.8
Leaf Tobacco & Beverage Crops (8)		-14.6	-21.7
Fishing (15)		3.9	-1.9
Mining			
Iron Ores (18)		0	-5.3
Other Non-Ferrous Metal Ores[1](22)		2.0	-9.3
Manufacturing			
Dairy Products (29)		8.2	-24.1
Processed Sea Foods (31)		-0.7	-18.2
Sugar (35)		49.7	*
Cotton Yarn (43)	U	0	-38.3
Cotton Fabrics (49)	U	0.8	-3.1
Wool Fabrics (51)	U	42.8	199.6
Chemical Fibre Fabrics (53)	U	6.7	-10.5
Plywood (62)	U	0.1	-19.2
Paper (67)	U	26.7	119.3
Basic Petrochemical Products (70)	P,E^-	11.8	-31.6
Chemical Fertilizers (79)	P	43.2	425.7
Synthetic Resins (82)	P	50.3	*
Agricultural Chemicals (86)	P,E^+	9.1	-12.6
Powder, Explosives & Pyrotechnic Products (89)	P	14.4	3.2
Rubber Products (93)	U	8.2	5.4
Pottery Products (94)	U	12.7	19.4
Cement (97)	U,E^-	54.4	*
Pig Iron (100)	P,E^-	7.5	35.4
Raw Steel (101)	P,E^-	10.0	26.9
Rolled Steel Products (102)	P	20.2	116.3
Non-Ferrous Metal Ingots (105)	P,E^-	20.4	240.9
Prime Movers (111)	T	32.0	137.3
Agricultural Machinery (112)	T,E^+	24.7	62.4
Metal-Working & Woodworking Machinery (113)	T	14.7	*
Household Electric Appliances (117)	T,E^+	36.0	79.2
Electrical Industrial Apparatus (118)	T	24.1	*
Household Electronic Appliances (120)	T,E^+	38.3	111.2

Table VIII-2 (Continued)

Name of Sector		NPR	EPR
Communication Equipment	T	10.7	0.7
Electronic Components (123)	T,E^+	17.5	24.5
Ships (124)	S	0.7	-36.3
Motor Vehicles (126)	S,E^+	38.5	620.6
Measuring, Medical & Optical Instruments (128)	S	31.9	*
Watches & Clocks (129)	S	30.8	64.8

Notes:
1) Including oil and LNG.
2) Including Tobacco products.
3) Including aluminum
4) N; excluded due to the sector's value added per unit prices being negative (W^C 0).
5) *; excluded due to the sector's value added per unit in domestic prices being negative (V^C 0).
6) In case of W^C 0, V^C 0 and W^C - V^C 0, EPRs have a negative sign.
7) NPR; nominal protection rate defined as the implicit tariff calculated as the price differential between domestic and foreign market. When such data are not available it is defined as the ratio of total import duties and the C.I.F. import values.

EPR; effective protection rate defined as the proportionate increment in value added per unit level of an activity brought about by the tariff structure over its free trade value added, i.e. a weighted average of its nominal protection and the protection of its inputs, calculated using nominal protection as above.

Unskilled Labor-Intensive Industry (U): Those industries whose skilled labor ratio (wage earned by skilled laborer/total wage) is less than 0.4 are defined as unskilled labor intensive industries.

Skilled Labor-Intensive Industry (S): It designates those industries whose skilled labor ratio is more than or equal to 0.4

Capital-Intensive Industry (P): Those industries whose capital intensive [(total value-added - compensation of employees - indirect taxes)/number of employee] is more than or equal to 0.8.

Technology-Intensive Industry (T): Those industries whose technology intensive (compensation of skilled employees/numbers of employee) is more than or equal to 0.5.

Energy-Intensive Industry E^-: Those industries whose energy intensity (total input coefficient of energy/total input coefficient) is more than or equal to 0.2.

Less Energy-Intensive Industry (E^+): Those industries whose energy intensity is less than 0.05.

Source: Hak Yong Rhee, "Protection Structure of the Developing Countries in South and East Asia," (unpublished paper, 1983), pp. 14-16.

During the 1980s, under President Chun, there has been a growing recognition by government and business leaders that the South Korean economy is becoming too complex for detailed government involvement. In addition, the intensification of trade protectionism in the United States (and elsewhere) and the adoption of the GATT subsidies code (1980) have pressured the South Koreans to modify their industrial development programs substantially. Government economic involvement has become less specific, the private sector has been given broader freedom (notably in banking), and many special preferences have been reduced or eliminated. The government's role has become more one of guiding than of directing the private sector. The fifth five-year plan (1982-1986) targets the development of skill-intensive production, with the government providing both funds and incentives to invest in a set of national research projects to develop semiconductor, bio-engineering and other technologies. It also calls for the liberalization of technology imports, the establishment of industry research institutes, and the upgrading of technology in small- and medium-sized firms. The sixth five-year plan (1987-1991) continues this emphasis, but with some changes. For the first time, regional development is an explicit goal.

C. Types of Subsidies*

As noted above, South Korea has used a wide variety of instruments to promote exports. Some of them are clearly allowable both under the GATT subsidy code and U.S. law, others are not. The latter fall into two categories under U.S. legislation: those considered to be explicit export subsidies and those domestic subsidies that fit certain criteria defined as being potentially harmful to the United States. We list the incentives below, and note whether they fall under one of those definitions.

1. Export Subsidies

a) Non-Material Incentives: Export Targets and Trade Promotion Meetings

Export targets for firms were established by the government in the early 1960s as conditions for access to preferential loans and other incentives. Today they are set by individual firms and modified, if necessary, by the government.* Aggregations of specific targets were also used by the government, to plan financial, infrastructure and other requirements.

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*Besides the sources cited above, this section draws heavily on the detailed material on subsidies provided in the Annex to this chapter; the U.S. Industrial Trade Commission, Foreign Industrial Targeting and Its Effects on U.S. Industries, Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan, USITC Publication 1632 (Washington, D.C.: January 1985); United States Trade with the Republic of Korea, Hearing before the Special Sub-Committee on United States-Pacific Rim Trade of the Committee on Energy and Commerce, House of Representative, 99th Congress, August 11, 1986, Serial #99-101; and U.S. Embassy, Seoul, Korean Government Support for Export Industries, Department of State Airgram, 81-Seoul A-81, June 16, 1983.

The management of export targets is conducted through The Monthly National Trade Promotion Meetings that began in the early 1960s, which are chaired by South Korea's president and attended by the economic ministers and important business leaders. The participants review export targets and discuss problems in meeting them. This provides the government with considerable feedback from the firms on overall market conditions and performance, and gives the companies a means to communicate problems that are subsequently resolved.**

The combination of export targets and monthly trade promotion meetings provides unconventional incentives in addition to the conventional incentives offered to exporters. Export targets provide a yardstick to measure performance. Those firms that meet their targets receive government approvals faster and special access to loans; in addition, they are subject to less rigorous tax audits. Moreover, this system has created a competitive spirit among firms, by giving awards to the best exporters at monthly trade promotion meetings and on Export Day. These awards became among the most highly publicized events in South Korea in the mid-1970s, and firms still take them very seriously. Although the importance of targets and meetings declined in the 1980s, many believe that they continue to be used to confer targeted support in ways that cannot be clearly identified in CVD cases.

b) Financial Incentives

The South Korean government has used its control of the financial system as one of its major economic policy tools, in ways very similar to Japanese policy in the 1950s and 1960s. Various types of short-, medium- and long-term financial instruments to give preference to specific South Korean industries, and especially to support exports.

Prior to June 1982, exporters enjoyed a lower interest rate for short-term loans than for similar domestic loans. Preferential short-term export loans include: foreign currency loans for overseas construction and services and won currency loans for the export of agricultural and marine products. Although preferential interest rates for exporters have been eliminated, various short-term loans may still constitute subsidies. For example, many firms rely on the quasi-legal curb market, if the official interest rate for export loans falls significantly below that on the curb market, this may reflect a subsidy. Moreover, the fact that these loans are still available for exporters is an important incentive in a credit rationed system such as the South Korean.

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*Rhee, Ross-Larson, and Pursell (1984), op. cit., pp. 16, 21-22.

**Ibid., pp. 17, 29-32.

Several sources provide medium-and long-term financing that has been targeted on exports, either directly or indirectly through limitations on their availability to specific firms or industries. The Export-Import Bank of Korea (KEXIM), established in 1976, is the primary source of subsidized medium- and long-term export financing. The program for medium-/long-term foreign currency loans for the import of capital equipment and raw materials authorizes banks dealing in foreign exchange to use foreign currency funds within a set ceiling to help companies finance the import of capital goods and raw materials for certain designated industries, including export industries. Targeted development loans are also available from the Korean Development Bank.

Preferential short-term interest rates for exports and preferential interest rates for priority industries were eliminated in June 1982, but targeting continues. Administrative discrepancies further bias the allocation of scarce credit between domestic and export loan programs. For example, the Bank of Korea has set different rediscount rates for short-term export and domestic loans. In 1983, in the CVD investigation covering the steel shapes and sheet and tapered tubular steel transmission structures, it was found that rediscount ratios in 1983 were 70 percent of the face value on export loans and 30 percent on domestic loans for large firms in the heavy and chemical industries. For small- and medium-sized firms, the domestic and exports loan rediscount rates were the same. In a credit-rationed system, the higher rediscount ratio for export loans provides a strong incentive for banks to support exporting firms.

The various loans have a mixed history in U.S. CVD cases; some have been found to constitute a subsidy, others have not. Most positive findings related to the preferred interest rates granted before June 1982. Several other financial programs that have been considered export subsidies in recent years have been dismissed in CVD investigations or modified or terminated by the South Korean government when found countervailable.

c) Tariff Incentives

The tariff system has been biased in favor of exports, mainly through two different mechanisms: tariff drawbacks and the tariff installment system. South Korean firms that import raw materials or components designed for incorporation into export products are eligible to receive a rebate, not only of the tariff on those imports but also of the special consumption tax, the defense tax, and the value-added tax. The rebate includes the tariff and tax on those products that are covered in the wastage allowance provision and tariff reductions on imported plant and equipment. Such drawbacks are normally not countervailable unless they are excessive, and most have not been found excessive in U.S. investigations.

The tariff installment system permitted tariffs on imports of capital equipment in certain designated industries to be paid in installments over a two- to five-year period, if the equipment is used in manufacturing of export goods. In the past, this was considered a subsidy, because the program was limited and benefits varied across eligible industries. However, in the 1986 tariff reforms of industry-specific export incentives, the tariff exemptions for strategic industries--including chemical, steel, electrical machinery, transporation equipment, and precision equipment--were abolished.*

d) Tax Incentives

Although tax benefits to promote the development of specific industries have been drastically reduced since 1982, incentives in the form of accelerated depreciation allowances still remain for six strategic industries: naptha cracking, steel, industrial machinery, electronics, shipbuilding, and aviation.** These are not based on industry-specific export targets, although most of the industries are also targeted for export growth.

The South Korean government still offers several tax incentives directed towards exporters and export activities.*** Plant and equipment used in making export products receive special accelerated depreciation allowances. This also applies to overseas businesses, including construction and plant exports. The value-added tax is zero for earnings derived from overseas construction and overseas services, while all exports are exempt from the domestic consumption tax. In addition to these benefits, a variety of other corporation tax benefits are linked to the exploitation of overseas markets, exports of construction services and industrial plants, and overseas port services. With the reduction or elimination of industrial targeting, these generally available incentives are usually not considered countervailable subsidies.

e) Preferential Treatment for General Trading Companies (GTC)

Firms obtain GTC status when they account for two percent of total exports for the year, export at least four items earning more than US $1 million, and have 20 or more branches overseas. Before 1980, GTC status provided significant benefits beyond those allocated to exporting firms in general. Since then these benefits have largely been abolished, with the exception of the prestige attached to the GTC label itself.****

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*United States International Trade Commission, Industrial Targeting (January 1985), p. 135.

**Ibid., p. 152.

***Ibid., pp. 143-145.

****Ibid., pp. 155-160.

f) Free Export Zones

The two free export zones in South Korea are the Mason Free Export Zone near Pusan and the Iri Free Export Zone in North Cholla province. Foreign and domestic enterprises that are allowed into these zones must produce exclusively for the export market, but this restriction will be eased in the future. The benefits of operating in these zones are generally designed to encourage foreign investment. They include exemptions from tariff and corporate, property, and value-added taxes on exports and imports. Companies are entitled to the same loan terms that are available to other exporters in South Korea; to free import of raw materials and capital equipment for the manufacture of export products; and access to industrial infrastructure facilities.* Some of these incentives have been found to constitute subsidies in earlier U.S. CVD cases.

2. Other Subsidies

Other types of subsidies include wastage allowances, the export-import link system, and price and rate reductions. Of these, the wastage allowance system has been the most important in the past. High-grade materials that can be imported only if used as inputs for export production are assigned a 0.5 percent to 10 percent "wastage allowance". This allows exporters to use or sell so-called "wasted" raw materials at a very high profit domestically, providing them with a supplemental income. In those U.S. CVD cases in which wastage was cited, it was usually not found to be excessive.

The export-import link system also has lost importance over time. Previously, imports of high-quality or popular foreign products were selectively linked to export performance. The importing firms could then sell these goods domestically at a high price and profit.

Preferential utility, railway freight, and port rates and other price reductions on government-controlled inputs have been cited in most countervailing duty investigations undertaken in the United States. Of the service rate charges, only reduced port charges have been found to constitute a countervailable subsidy, and they appear to have been eliminated. There also have been cases in which it has been alleged that Pohang Iron and Steel Company (POSCO) provides steel products to other South Korean firms for incorporation into exports at lower than market prices. Since POSCO is government-owned, this would constitute a subsidy if it is true. Most U.S. CVD cases have found no countervailable bounty or grant in this connection.

C. Trade Disputes Involving South Korean Subsidies

South Korean subsidies became a source of tension with the U.S. in the mid- to late 1970s, as South Korean exports rapidly penetrated U.S. markets in sensitive product areas. Between 1972 and the present, South Korea has faced 12 countervailing duty cases, although in several of these more than one filing was aggregated under one case number. Most of the disputes involved steel products and were filed during 1982-84. The non-steel cases involved footwear, handbags, and bicycle tires and tubes. Of the cases filed, four were found negative or de minimus. All of the positive findings involved low rates of subsidy, which have since been removed. The programs cited in the CVD cases are summarized in Table VIII-3.

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*Ibid., p. 144.

South Korea became a signatory to the subsidy code in June 1980. Of the various open CVD cases that existed in the early 1980s, all have been dropped, either because of the elimination of the identified subsidies or through the negotiation of the voluntary export restraint agreement on steel. By February 1987, the National Trade Estimate: 1986 Report on Foreign Trade Barriers, prepared by the Office of the United States Trade Representative, reported only one case in which the Korean Export/Import Bank offered financing terms that did not conform to the terms of Korea's GATT subsidies code commitment, and this case did not affect U.S. producers.* It went on to note that "on February 21, 1986 a formal exchange of notes took place that confirmed that South Korea was refraining from using export subsidies materially incompatible with its obligations under the GATT subidies code."** South Korean sources report that the country has faced no countervailing duties in any industrial country since the end of 1984, although some 31 products were facing anti-dumping duties in the second quarter of 1986.

D. Impact of South Korean Subsidies

Since the mid-1950s, South Korea has used a wide array of both selective and general export subsidy programs as an adjunct to its industrialization program. Various analytical studies find that most of subsidies were used as offsets to the costs of import-protection and other import-substitution policies on exporting firms. In general, the subsidies were used to help create internationally competitive firms and have been reduced or eliminated as that goal was achieved.

Subsidies have generally not been large enough or continued long enough to create extensive distortions and costs in South Korea's economy, with two main exceptions. The first is agricultural protection and subsidies which, although outside the GATT code, have been growing in recent years as world market prices, particularly for rice, have declined. The second major area was the overemphasis on heavy capital-intensive industry expansion in the late 1970s, leading to excess capacity and, in some cases, export sales at "dumping" prices. The import-substitution policies that led to the creation of excess capacity are not defined as subsidies under current legislation, but they have clearly contributed to the very large number of anti-dumping cases filed against South Korean products in the United States.

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*Office of the United States Trade Representative, National Trade Estimates 1986 Report on Foreign Trade Barriers, p. 170.

**Ibid.

Table VIII-3

SOUTH KOREAN SUBSIDY PROGRAMS: U.S. INVESTIGATIONS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Total # of Cases	12	8
Programs:		
Preferential Export Financing	2	2
Preferential Tax Incentives for Exporters	4	4
Mason Free Export Zone	4	2
Preferential Wire Rod Rates	1	
Preferential Utility Rate	4	1
Tax Exemptions for Government Owned Firms	1	
Preferential Port Charges	2	1
Preferential Financing	1	
Government Loan Guarantees	1	
Wage Controls for Government Run Firms	1	
Govt. Purchases of Steel at Inflated Prices	1	
Government Capital Grants	1	
Indirect Subsidies to Purchasers of Machinery Used to Make Iron or Steel	1	
POSCO's Dual Pricing System	1	1
Loans at Favorable Foreign Currency Exchange Rate	3	
Tariff Incentives	2	1
Foreign Capital Inducement Law	4	1
Short-Term Preferential Financing	1	1

Table VIII-3 (Continued)

SOUTH KOREAN SUBSIDY PROGRAMS: U.S. INVESTIGATIONS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Short-Term Export Financing under the Export Financing Regulations	3	2
Accelerated Depreciation	2	2
Medium and Long-Term Credit	2	
Commercial Banks	2	
Specialized Bank	2	
Development Institutions (KDB)	2	
National Investment Fund	2	
Fund for Expanding Export Facilities	2	
Import Duty Deferrals	2	
Investment Tax Credit	2	
Subsidized Steel Inputs		
Equity Infusions into Dingjin	2	
Tariff Reductions in Imported Plant and Equipment	2	1
Export Credit Insurance	3	
Training Aid	2	
Financial & Technical Assistance for Raw Material Purchases	2	
Special Depreciation under the "Act Concerning the Regulation of Tax Reduction and Exemption"	1	1
Government Equity Infusions into POSCO	1	1
POSCO's Purchases of Domestic Iron Ore	1	

Table VIII-3 (Continued)

SOUTH KOREAN SUBSIDY PROGRAMS: U.S. INVESTIGATIONS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Export Credit Financing from the Export-Import Bank of Korea	1	1
Tax Incentives for Exporters Under Articles 22, 23, and 24	1	1
Special Depreciation under Article 11	1	
Export Guarantees from Export-Import Bank of Korea	1	

Source: United States Department of Commerce--Import Administration - Central Records Information Management System.

By most standards, South Korean subsidy policies have been highly successful in stimulating economic development and helping to make South Korea one of the world's principal exporting nations. It is impossible to separate quantitatively the effect of subsidies from other industrial targeting policies that have contributed to South Korea's success, but subsidies clearly played an important role in the complex set of policies supporting economic growth. In their absence, South Korea's import- protection would clearly have biased the system against exports, and, barring other changes, South Korea would have grown much more slowly than it in fact did.

IX. SINGAPORE*

A. Characteristics of Singapore's Economic Policy

Singapore is one of the most successful of the newly industrialized countries (Table IX-1 provides economic indicators). Once considered incapable of even surviving as an independent country because of its free port status and lack of natural resources, Singapore has confounded its detractors and posted one of the highest growth rates in the developing world.

Although Singapore is often praised for its free market policies, the government has had an important role in regulating and guiding economic activity, ranging from its extensive administrative and regulatory activities to its active involvement in production and investment decisions through a plethora of state corporations. The success of the government's policies has been due to the quality of its personnel and to a flexible technocratic approach. In addition, political stability has been maintained by minimizing popular discontent through social welfare measures and grassroots political institutions controlled by the government.

During the first decade after independence in 1959, Singapore promoted economic development through a combination of inducements (particularly tax relief) for manufacturing investments, infrastructure construction, labor force training, and selective import-substitution. A few local industries were protected by tariffs and quotas and by price preferences on government procurements. The brief political union with Malaysia, from 1963 to 1965, had little impact on economic policy. After the breakup of the union, Singapore began to dismantle import-substitution and to establish free trade zones. This process of import-liberalization was accelerated after the British decision in the late 1960s to rapidly withdraw its military bases, which had accounted for nearly one-fifth of Singapore's income and employment.

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*This chapter draws on a variety of sources. In particular, the research on Singapore for this project was undertaken jointly with another Hudson Institute project, Trade Policy Formulation in Selected Developing Countries. See the final report by the same name by J.W. Wheeler and Perry L. Wood (Indianapolis, IN: April 1986) and a background paper by Philip J. Deluty and Perry L. Wood,-"Singapore: The Dynamics of a Free Trade Regime," Hudson Institute Paper, HI-3749/2-P, (March 11, 1986). See also: Augustine H.H. Tan and Ow Chin Hock, "Singapore," Chapter 9 in Bela Balassa and Associates, Development Strategies in Semi-industrial Economies (Washington, D.C.: The World Bank, 1982); You Poh Seng and Lim Chong Yah, Singapore: Twenty-five Years of Development (Singapore: Nan Yang Xing Zhou Lianhe Zaobao, 1984); Linda Lim and Pang Eng Fong, Trade, Employment and Industrialization in Singapore (Geneva: International Labor Office, 1986); David Lim, "Industrial Restructuring in Singapore," Asian Employment Programme Working Papers, International Labour Office, ILO-ARTED, Bangkok (June 1984); and Hafiz Merza, Multinationals and the Growth of the Singapore Economy (New York: St. Martin's Press, 1986).

Table IX-1

SINGAPORE PRINCIPAL ECONOMIC INDICATORS
(Percentages)

Average Annual Rates of Growth	1965-73	1973-84
Inflation	3.1	4.4
Real GDP	13.0	8.2
Manufacturing Production	17.0	7.3
Volume of Exports	N.A.	10.4
Structure of Production	**1965**	**1984**
Agriculture	3	1
Industry	24	39
Services	73	60
Structure of Merchandise Exports	**1965**	**1983**
Fuels, Minerals and Metals	21	31
Other Primary Commodities	44	13
Textiles and Clothing	6	4
Machinery & Transport Equipment	10	31
Other Manufactures	18	22

Sources: International Financial Statistics Yearbook 1986 (Washington, D.C.: International Monetary Fund, 1986); and World Development Report 1986 (Washington, D.C.: International Bank for Reconstruction and Development, 1986).

This shock, combined with a growing interest in adopting a more outward-looking industrialization strategy, led to the adoption in 1967 of the Economic Expansion Incentives (relief from income tax) Act, which introduced a variety of measures to promote exports and attract foreign investors. Import restrictions also began to be removed. The number of items subject to tariffs fell from 398 in 1969 to only 197 in 1973, and the tariffs that remained were quite low. Similarly, the number of items subject to quotas declined from 26 in 1969 to just 3 in 1973.

The Employment Act of 1968 and the Industrial Relations (amendment) Act of 1968 broadened an employer's discretion on promotions, internal transfers, hirings, and dismissals by weakening the role of collective bargaining; it also reduced labor costs by limiting the freedom to grant bonuses, paid annual leave, and various retrenchment, overtime and other benefits such as payments for retirement. Hours of work were also expanded. The response to these initiatives was quite rapid. Exports and economic growth surged, and by 1971 multinational corporations "...accounted for 26 percent of all firms, 63 percent of employment, 75 percent of value-added, and almost 75 percent of manufactured exports, excluding re-exports."*

The early export-promotion emphasis was on the development of labor-intensive export industries. By the early 1970s, however, there was movement toward promoting higher technology and capital-intensive production. The labor surplus that had been of such great concern was absorbed very rapidly. Incentives were modified to attract higher technology industries that catered to both regional and world markets in the 1970 Economic Expansion Incentives (relief from income tax) Amendment Act. In addition, immigration was liberalized, the government began to promote on-the-job training, and the educational system was restructured to be more responsive to corporate needs. The 1974- 75 world recession delayed the goal of shifting towards less labor-intensive industries, and no major industrial policy changes were introduced during the recession or the recovery (1976-1978).

In 1979, the government launched its "second industrial revolution," designed to push the economy into higher value-added activities. Some aspects of this policy involved additions to existing programs--additional investment incentives were introduced for desired industries; and training and educational facilities were expanded both for new labor force entrants and for workers in industry.** But there were also new programs, notably systematic raising of wage levels in order to discourage low-wage industrial activity. Eleven industries were selected for investment promotion in the 1980s.*** The optimism with which Singapore entered the 1980s was greatly challenged by events (the second oil shock, the global recession, etc.); by 1985, considerable pessimism had emerged about Singapore's economic future, and policies had to be reassessed. Unemployment was growing, some industries were in serious trouble, foreign demand was expected to remain stagnant, etc.

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*Tan and Hock, p. 283.

**Linda Lim and Pang Eng Fong, Trade, Employment and Industrialization in Singapore (Geneva: International Labour Office, 1986).

***These industries are: automotive components, medical and surgical apparatus and instruments; machine tools and machinery; specialty chemicals and pharmaceuticals; computers, computer pheriperal equipment and software development; electronic instrumentation; optical instruments and equipment, including photocopying machines; precision-engineering products; advanced electronic components; hydraulic and pneumonic control systems; and key supporting industries for the above.

Indeed, the situation had become serious enough that a government panel, headed by Lee Hsien Loong, the prime minister's son, was created to assess Singapore's economic problems. This panel undertook a broad-ranging investigation of Singapore's economic problems and strengths and proposed an extensive array of corrective measures. Many of these measures have been adopted including substantial cuts in wage-related costs, tax reductions, some reductions in financial costs, and a variety of measures to reduce operating costs for firms (See Table IX-2 for a summary of some of the changes).

B. Role of Subsidies in Singapore's Economic Policy

Like Taiwan and South Korea, Singapore has focused on rapid economic growth as the primary national imperative, while at the same time taking special care to improve income distribution and the social welfare of the populace. Indeed, Singapore's highly developed welfare policies are often contrasted with the strong market orientation of its economic policy. The incentives used in meeting both the growth and welfare goals have included subsidies. Unlike South Korea and Taiwan, Singapore has no agricultural sector for which special income enhancement was required. But Singapore is a multi-ethnic country (mainly Chinese, Malay, and Indian) that faced considerable differences and tensions among the groups in the years after independence, and strong social welfare policies were used to narrow economic and quality of life differences, and to defuse political discontent. Social welfare policies took the form mainly of subsidized housing, education, and health services; direct transfers to individuals for social welfare purposes are insignificant.*

Industrial incentives were designed to upgrade industrial production toward higher skill requirements, enhance technology acquisition, attract foreign investors, and improve the competitiveness of commercial and financial services. Industrial targeting has gone through several stages, and the specific incentives used have changed accordingly, although the basic framework of incentives laid down by the end of the 1960s has been largely unchanged. The major types of industrialization incentives include: the provision of high-quality infrastructure and services, with preferential treatment provided to "pioneer" industries; various forms of income tax relief to "pioneer" and various other favored industries; other tax reductions and exemptions; preferential short-, medium- and long-term financing, which can include equity participation for selected firms and industries; a wide range of technical, training, marketing, and other advisory and support services;

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*See Mukal G. Asher, "The Fiscal System of Singapore," in You Poh Seng and Lim Chong Yah, Singapore: Twenty-five Years of Development (Singapore: Nan Yang Xing Zhou Lianhe Zaobao, 1984), p. 97.

Table IX-2

SINGAPORE, WHERE COSTS ARE CUT

Cost Changes	Old Rate	New Rate	Remarks
Wage Costs			
Employer's monthly Central Provident Fund Contribution	25%	10%	From 1 April 1986.
Payroll Tax	2%	0%	Suspended as from 1 April 1985.
Skills Development Fund Levy	2%	1%	In April 1985, the levy was reduced from 4% to 1%. With effect from 1 April 1986, levy reduced further to 1% for two years.
Wage Increments	--	--	Government employers and trade unions agreed on wage restraint for next two to three years.
Tax Changes			
Company Income Tax	40%	33%	Effective from Year of Assessment 1987
Property Tax Rebate	30%	50%	Rebate for industrial and commercial properties and land, from 1 July 1986 to 31 December 1986.
Personal Income Tax Rebate	10%	25%	25% rebate on tax payable for Year of Assessment 1986 is in addition to existing 10% rebate on tax on the first $10,000 of chargeable income. For Year of Assessment 1987, maximum tax rate will be reduced from 40% to 33%.
Tax on electricity and gas charges, sanitary appliance fees and refuse removal charges	10%	0%	Tax suspended by PUB for two years from 1 November 1985.

Cost Changes	Old Rate	New Rate	Remarks
Financial Costs			
Small Industries Finance Scheme	9%	7.75%	Reduction in interest rate on new and existing loans from 1 August 1985.
Export Factoring	--	6%	Facility introduced from 12 November 1985.
Operating Costs			
Charges for international telephone and telex services, telephone extension, pager, modem and international leased circuits	--	10-50% reduction	From October/November 1985.
Rebates for PSA warehouse and handling charges	--	10-33%	From 1 August 1985. This is in addition to the incentives and rebates for port tariffs announced in June 1985.
Rebate for composite port dues for vessels which stay in port not more than five days	--	50%	From 1 April 1986.
Rebate for stevedoring charges for containers	--	Another 10%	From 1 April 1986.
Discount on total stevedoring charges for the year for shipping lines with throuGhputs exceeding 100,000 TEUs annually.	--	5-15% Discount	From 1 April 1986.
Free storage for containers for first 28 days.	--	--	From 1 April 1986.

Cost Changes	Old Rate	New Rate	Remarks
Operating Costs			
Reduced fees payable by licensed contractors performing services on vessels at PSA wharves	$1,000 p.a.	$400 p.a.	From 1 April 1986.
Rent rebate by ITC for: land	--	15%	From 1 January 1986-31 December 1987.
building	--	25%	From 1 January 1986-31 December 1987. Also easier payment terms for land and building rental and purchase of building.
Rebate for Jurong port facilities	--	10-15%	For 17 months from 1 August 1985.
Rent rebate by HOB for industrial land and commercial/industrial premises	--	15%	Rebate for tenants of commercial/industrial premises effective until end-December 1987. Also a limited rent-free period for fitting up renovation.
Much reduced rent or premium for offices, factories, and warehouses for leasers who extend leases expiring between 1 April 1986 and 1999 or who further invest	--	--	Buildings to be assessed on actual construction cost. Premium will be levied from actual date of construction.
Reduced airport rentals, concessions fees for airport shops, and ground handling and aviation fuel handling fees by CAAS	--	15% reduction	From 1 August 1985.
Reduced PUB rates for: electricity	--	9%	From 1 February 1986.
gas	--	2%	From 1 February 1986.

Source: Far Eastern Economic Review, 8 January 1987, p. 68.

and direct government participation in the provision of goods and services through statutory boards (primarily to provide infrastructure, utility, and other social goods and services) and public or semi-public enterprises.

In a country as small and outwardly-oriented as Singapore, it is very difficult to distinguish export incentives from domestic incentives, although some are explicitly export focused. Private sector targeting is primarily through the designation of pioneer status, which give firms the ability to apply for various special programs. In addition, government enterprises have been used heavily in moving Singapore into desired industries. Contrary to most countries, however, Singapore runs its government enterprises on a for-profit basis, and does not use subsidies to cover losses.

C. Types of Subsidies*

Some of the various export and domestic incentives noted above are clearly allowable under GATT and U.S. legislation, while others have been found to be countervailable in U.S. CVD cases. Some are more ambiguous--they were either not investigated or were found not to have been used. Since Singapore has not signed the subsidies code, a material injury finding is not required, and the mere existence of a subsidy can require imposition of a countervailing duty. The major forms of subsidies are listed below.

1. Export Subsidies

Import Duty Exemption: Exporters are exempted from import duties on all imports. With limited exceptions, Singapore is a "free port," and this exemption is not needed. Further, such indirect taxes as general sales taxes and value-added taxes are not used and thus do not need to be offset.

Export Incentives: An explicit export subsidy is available for approved exports of firms that do not qualify for pioneer status (see below), but do fit the general industrial promotion goals and meet certain size, level of investment, technology, skill, volume of exports, and ownership criteria. For qualifying firms, the tax on profits from exports is reduced from 40 percent to 4 percent, for a period of five to 15 years.

Warehousing and Servicing Incentive: This incentive reduces the profits tax from 40 percent to 20 percent on profits derived from warehousing operations and specified export services from a specified base for 5 years.

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*The Annex provides more information on these programs. See also Singapore International Chamber of Commerce, Investors Guide to the Economic Climate of Singapore, issued annually, and Singapore Trade Development Board, Annual Report.

International Consultancy Services Incentive: Selected services exported by Singapore-based consultancy firms and engineering contractors that meet certain criteria can receive a five-year reduction in taxes from 40 to 20 percent on profits above a base level.

International Trade Incentives: Trading companies that export certain products can receive a reduced tax rate of 20 percent on export profits for five years above a calculated base.

Export Expansion Schemes: The Trade Development Board administers several programs to encourage Singapore manufacturers and traders to increase their exports. They mainly constitute double tax deductions for a variety of overseas marketing and promotional activities.

Export Financing: The Monetary Authority of Singapore rediscount facility provides short-term loans through the exporters' bank at preferential rates for pre-export and export financing.

Export Credit Insurance: The Export Credit Insurance Corporation provides insurance coverage against nonpayment for exporters who export on credit. It also offers direct credit guarantees to banks on export credits for exporters and for overseas buyers.

2. Domestic Subsidies

Pioneer Status: The fundamental domestic tax incentive has been, and remains, pioneer status. This provides an exemption from profits tax for a period of from 5 to 10 years, based on various criteria. For certain long gestation or advanced technology projects, the exemption can be extended beyond 10 years. (Most, but not all, pioneer status firms are foreign-owned.)

Investment Allowance: An alternative to pioneer status for qualifying projects is a tax exemption on profits up to a maximum of 50 percent of a company's fixed investment in the year of that investment for up to five years, with carry- forward provisions. This allowance may be used in addition to normal accelerated depreciation without reducing its benefit.

Expansion Incentive: Manufacturers making a minimum $10 million investment in production equipment may be granted a tax exemption on the resulting increase of income for up to five years.

Accelerated depreciation may be claimed on expenditures for plant and equipment.

Tax exemption on interest for approved foreign loans for the purchase of productive equipment can be granted.

Skills Development Fund Grants (SDF): SDF provides subsidies to firms for approved employee training programs, for the interest cost incurred in the purchase of automation equipment, and for hiring external experts to engage in short-term analysis of upgrading operations.

Capital Assistance Scheme: This provides equity and/or fixed cost loans to projects of economic and/or technological benefit to Singapore.

Small Industries Finance Scheme: Jointly operated by the EDB and the DBS and several private banks, this scheme provides financial assistance to small locally-owned enterprises.

Project Development Assistance Scheme: The EDB provides dollar-for-dollar matching grants to help local manufacturing companies develop or improve products or processes.

Other tax incentives exist to promote industrialization, and increasing capital- and skill-intensity. These include a variety of accelerated depreciation and other tax reduction incentives to encourage capital investment and to accelerate automation, computerization, and research and development spending.

Various special incentives are also provided to foreign investors and to foreign financial institutions that locate in Singapore.

D. Trade Disputes Involving Singapore Subsidies

Singapore has had relatively few trade disputes with the U.S. over subsidies, despite the fact that some of its programs clearly justify investigation. After Singapore did not sign the GATT subsidies code in 1980, several cases emerged. The investigations also collected information on a variety of programs that were not cited by petitioners as potential subsidies. Three cases were filed: 1) on certain textile mill products and apparel; 2) on certain refrigeration compressors; and 3) on carbon steel wire rod. (A summary is provided in Table IX-3.) The investigation of textile mill products and apparel found de minimis net countervailable benefits and brought a final negative determination. The refrigeration compressors case found that a net bounty or grant existed. Countervailing duties were suspended on the agreement with the government of Singapore that an export charge will offset completely the total bounty or grant of 4.92 percent ad valorem. In the carbon steel wire rod case, the programs under the investigation were found not to be countervailable.

Because of the limited nature of the case history, many of the potentially troublesome incentive programs were found not to be used by the firms under investigation, although most of the programs described above were cited. Of the programs used, the most important one that has been identified

Table IX-3

SINGAPORE SUBSIDY PROGRAMS: U.S. INVESTIGATIONS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Total # of Cases	3	2
Programs:		
Economic Expansion Incentive Act	3	1
Singapore Monetary Authority Rediscount Facility	3	2
Singapore Economic Development Board		
The Capital Assistance Scheme	3	
Loans	1	
Loan Guarantees	1	
The Product Development Assistance	2	
Grants	1	
The Skills Development Fund	2	
Training Grants	1	
Interest Grants for Mechanization	1	
Development Consultancy Grants	1	
Export Credit Insurance Corporation	2	
Double Deduction of Export Promotional Expenses	2	1
Training Center for Apparel Workers	1	
Research & Development Tax Incentives	2	
One or More Years of "Pioneer" Status	1	
Double Deductions from Taxable Income for Research & Development Expenditures	1	
Deductions for Certain Expenses, Not Ordinarily Deductible	1	
An Investment Allowance of up to 50 Percent of Research & Development Capital Investment	1	

Table IX-3 (Continued)

SINGAPORE SUBSIDY PROGRAMS: U.S. INVESTIGATIONS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Accelerated Depreciation over Three Years for All Plant and Machinery Purchased for Research & Development	1	
Venture Capital Tax Incentive	1	
Industrial Estates	1	
Rebate on Industrial Estate Rentals by JTC	1	
Withholding Tax Exemption under Section 13(2) of the Singapore Income Tax Act	1	
Pubic Utilities Board Surcharge Exemption	2	
Payment of Income Taxes in Installments	1	

Source: United States Department of Commerce--Import Administration--Central Records Information Management System.

as an export subsidy under the meaning of U.S. law is that part of the Economic Expansion Incentives Act that designates a company an export enterprise. The income tax exemption granted export enterprises represented the full countervailable subsidy in the refrigeration compressors case. In addition, access to preferential financing through the Monetary Authority of Singapore (including differential rediscounting between export and other short- term loans) is in principle a countervailable subsidy. In the compressors case, no duty was imposed, but the suspension agreement between the U.S. government and the government of Singapore prevents the companies involved from applying for or receiving such loans. In the textile mill and apparel products case, this program was found to constitute a countervailable benefit, but at an extremely low rate (0.005 percent ad valorem for textile mill products and 0.013 percent ad valorem for apparel). In addition, the textile mill products and apparel case found the double deduction of export-promotion expenses to confer a net countervailable benefit, but at a rate for the period under investigation of less than 0.001 percent ad valorem for apparel.

Although, in the case history, most incentive programs used by Singapore either have not constituted subsidies or have constituted relatively small subsidies, it is clear that these programs are structured in such ways as to be potentially countervailable. Indeed, in private conversations with Singaporean officials, it was clear that, if it were desirable to promote a particular firm or industry, a way would be found to do so, regardless of GATT rules and U.S. legislation.

E. Impact of Singapore's Subsidies

By any standards, Singapore's economic policy has been highly successful. The imperatives of dealing with the world market have constrained the introduction of policies that significantly distorted costs and incentives. The magnitude of explicit subsidies that were used was always constrained by what the country could afford and by a very pragmatic assessment of their effectiveness. This can be seen in the structure of effective protection rates (Table IX-4).

Overwhelmingly, the largest subsidies were those that taxed income from economic activity in order to subsidize social welfare programs. These policies were successful in eliminating many of the social and political tensions that existed in the city-state in its earlier years. Indeed, they have become so successful that the heavy hand of the benevolent technocracy is being challenged, as individuals want more say in the major programs that affect their daily lives.

The economic development policies have also achieved their broad goals. Singapore absorbed its excess labor by moving rapidly into labor-intensive industry and subsequently began to drive into more technology-intensive manufacturing and services, based largely on attracting capital inflows. Subsidies are viewed by the government as an integral part of the policy mix that created this favorable environment. Technical analyses, however, do not suggest that specific incentives were a major factor in attracting firms to

Table IX-4

PROTECTION IN SINGAPORE

Name of Sector (I-O Code)		NPR	EPR
Agriculture, Forestry & Fishing			
Polished Rice(1)		0	-0.5
Leaf Tobacco & Beverage Crops (8)		323.4[2]	403.1[2]
Fishing (15)		0	-0.6
Mining			
Iron Ores (18)		0	-0.8
Other Non-Ferrous Metal Ores[1](22)		0	-2.7
Manufacturing			
Dairy Products (29)		0	-0.7
Processed Sea Foods (31)		0	-1.0
Sugar (35)		0	*
Cotton Yarn (43)	U	0	-0.8
Cotton Fabrics (49)	U	0	-0.7
Wool Fabrics (51)	U	0	-1.3
Chemical Fibre Fabrics (53)	U	0	-1.3
Plywood (62)	U	0	-1.4
Paper (67)	U	0	-2.6
Basic Petrochemical Products (70)	P,E^-	0.7	0.3
Chemical Fertilizers (79)	P	4.4	29.9
Synthetic Resins (82)	P	1.5	*
Agricultural Chemicals (86)	P,E^+	4.4	13.9
Powder, Explosives & Pyrotechnic Products (89)	P	4.4	9.5
Rubber Products (93)	U	0	-3.5
Pottery Products (94)	U	0	-1.4
Cement (97)	U,E^-	0	*
Pig Iron (100)	P,E^-	2.1	14.4
Raw Steel (101)	P,E^-	2.1	5.1
Rolled Steel Products (102)	P	2.1	3.9
Non-Ferrous Metal Ingots (105)	P,E^-	9.0	-5.3
Prime Movers (111)	T	0.9	-1.1
Agricultural Machinery (112)	T,E^+	0.9	-1.7
Metal-Working & Woodworking Machinery (113)	T	0.9	*
Household Electric Appliances (117)	T,E^+	0	-2.5
Electrical Industrial Apparatus (118)	T	0	*
Household Electronic Appliances (120)	T,E^+	0	-1.6

Name of Sector		NPR	EPR
Communication Equipment	T	0	-1.7
Electronic Components (123)	T,E^+	0	-1.3
Ships (124)	S	0	-2.2
Motor Vehicles (126)	S,E^+	1.0	-5.2
Measuring, Medical & Optical Instruments (128)	S	0	*
Watches & Clocks (129)	S	0	-2.1

Notes:
1) Including oil and LNG.
2) Including tobacco products.
3) Including aluminum
4) N; excluded due to the sector's value added per unit prices being negative (W^C 0).
5) *; excluded due to the sector's value added per unit in domestic prices being negative (V^C 0).
6) In case of W^C 0, V^C 0 and W^C - V^C 0, EPRs have a negative sign.
7) NPR; nominal protection rate defined as the implicit tariff calculated as the price differential between domestic and foreign market. When such data are not available it is defined as the ratio of total import duties and the C.I.F. import values.

EPR; effective protection rate defined as the proportionate increment in value added per unit level of an activity brought about by the tariff structure over its free trade value added, i.e. a weighted average of its nominal protection and the protection of its inputs, calculated using nominal protection calculated as above.

Unskilled Labor Intensive Industry (U): Those industries whose skilled labor ratio (wage earned by skilled laborer/total wage) is less than 0.4 are defined as unskilled labor intensive industries.

Skilled Labor Intensive Industry (S): It designates those industries whose skilled labor ratio is more than or equal to 0.4

Capital Intensive Industry (P): Those industries whose capital intensive [(total value-added--compensation of employees--indirect taxes)/number of employee] is more than or equal to 0.8.

Technology Intensive Industry (T): Those industries whose technology intensive (compensation of skilled employees/numbers of employee) is more than or equal to 0.5.

Energy Intensive Industry E^-: Those industries whose energy intensity (total input coefficient of energy/total input coefficient) is more than or equal to 0.2.

Less Energy Intensive Industry (E^+): Those industries whose energy intensity is less than 0.05.

Source: Hak Yong Rhee, "Protection Structure of the Developing Countries in South and East Asia," (unpublished paper, 1983), pp. 14-16.

Singapore. Instead, it seems that they were attracted by the positive business oriented environment, the open trading system, the minimal red tape, and the hardworking, skilled labor force. Incentives, if they are mentioned at all, are typically brought up only in the context of the positive government-business relationship. Thus, the political difficulties resulting from not signing the subsidy code and from maintaining programs that appear to be subsidies under GATT and U.S. legislation seem to be an unnecessary political and administrative burden on the government of Singapore.

X. TAIWAN*

A. Characteristics of Taiwan's Economic Policy

Taiwan's successful transformation from an agricultural to an industrial economy over the last three decades has often been referred to as an economic miracle (see Table X-1 for economic indicators). Indeed, few countries have ever achieved the rapid yet stable growth that characterized Taiwan's experience. When the Kuomintang (KMT) retreated to Taiwan in 1949, they faced many obstacles to achieving economic progress. Taiwan was cut off from its major trading partners (Japan and China), inflation was rampant, the industrial infrastructure had been damaged due to the war, and when the Japanese left the island, they created a severe shortage of managerial personnel. Nevertheless, by first concentrating on stabilizing its domestic economy and then implementing outward-looking development strategies that exploited its comparative advantages--in particular, its industrious and relatively well-educated labor force--Taiwan has been able to achieve remarkable economic progress.

Much of the credit for Taiwan's economic growth can be attributed to a stable government and consistent, financially conservative, yet pragmatic and growth-oriented economic policies. The major policy initiatives in the early years included: land reform, currency reform, and the adoption of inward-looking, import-substitution biased, industrial and trade policies. These policy efforts were supported with a substantial U.S. aid program.

By the mid-1950s, the government had perceived the limitations of import-substitution in a domestic market and concluded that further industrialization would have to be based on export growth. As early as 1955, some export incentives were introduced, but it was not until 1958-60 that a series

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*This chapter draws on a variety of sources. In particular, the research on Taiwan for this project was undertaken jointly with another Hudson Institute project, Trade Policy Formulation in Selected Developing Countries. See the final report by the same name by J.W. Wheeler and Perry L. Wood (Indianapolis, IN: Hudson Institute, April 1986) and a background paper by John Tedstrom, "Trade Policy Formulation in Taiwan," Hudson Institute Paper, HI-3748-p/2, March 12, 1986. See also T.H. Lee and Kuo-shu Liang, "Taiwan," Chapter 10 in Bela Balassa and Associates, Development Strategies in Semi- Industrial Economies (Washington, D.C.: The World Bank by Johns Hopkins University Press, 1982); Lawrence J. Lau (ed.), Models of Development: A Comparative Study of Economic Growth in South Korea and Taiwan (San Francisco, Ca: ICS Press, 1986); Yuan-li Wu, Becoming an Industrialized Nation: ROC's Development on Taiwan (New York: Praeger Publishers, 1985); Kwoh-ting Li and Tzong-shian Yu (eds.), Experiences and Lessons of Economic Development in Taiwan (Taipei: Academia Sinica, 1982); and Conference on U.S.-Taiwan Economic Relations (Taipei: Chung-Hua Institution for Economic Research, March 27-28, 1985).

Table X-1

TAIWAN ECONOMIC INDICATORS

PERIOD	POPULATION	GROSS NATIONAL PRODUCT	PER CAPITA GNP	AGRICULTURAL PRODUCTION	INDUSTRIAL PRODUCTIONS	TRANSPORTATION & COMMUNICATIONS	EXPORTS	IMPORTS
GROWTH RATE (%)								
PERIOD AVERAGE:								
1953 - 1962	3.5	7.5	4.1	4.8	11.7	9.1	19.5	17.0
1963 - 1972	2.9	10.8	8.1	4.0	18.5	11.6	29.9	23.5
1973 - 1983	1.9	7.8	5.7	1.8	10.0	7.2	21.4	22.5

SOURCE: COUNCIL FOR ECONOMIC PLANNING AND DEVELOPMENT, REPUBLIC OF CHINA, TAIWAN STATISTICAL DATA BOOK, 1984.

of major policy reforms totally reoriented Taiwan's industrialization strategy. The severely overvalued structure of multiple exchange rates for the Taiwan dollar was collapsed into a single devalued rate. The government also initiated a process of tariff reductions and began abolishing foreign exchange allocation controls; it slowly liberalized and ultimately eliminated the commodity import quota system, and eased and eventually removed the restrictions on imports of materials and equipment to be used in the production of exports. At the same time, the criteria for granting protection to domestic manufactures were progressively tightened.

The government also began introducing an array of new export incentives and institutions. These included tariff and tax rebates and reductions, special privileges for the use of foreign exchange earnings, low interest rate loans and other financial incentives, provision of export-promotion facilities, permission for selected manufacturers and trade organizations to implement private sector export subsidy schemes, and the establishment of duty-free export processing zones.

This shift from an import-substitution bias toward an export promotion bias was combined with general economic reforms aimed at liberalizing the domestic economy and improving the investment climate. Monetary and fiscal policies were designed to keep inflation low and to ensure a positive real rate of interest on savings. These policies were highly successful as production, exports, and real income boomed.

In the early 1970s, the quadrupling of petroleum prices and the explosion of worldwide inflation challenged Taiwan's success and, in some respects, forced alterations in the government's economic strategy. In the short run, the Taiwanese government responded by tightening credit, raising the prices on a variety of government-provided goods and services, and forcing other adjustments in the domestic economy. This shock therapy proved successful, and Taiwan quickly returned to rapid economic growth and trade surpluses.

The longer-term impact on economic strategy was to identify certain weaknesses in the policy mix that required attention. Most importantly, it became clear that a successful continuation of outward-oriented expansion required upgrading industries and exports from those based on unskilled labor to those that utilized more skilled labor, higher technology, and greater capital-intensity.

The economic difficulties of the early 1970s raised the government's interest in expanding the backward linkages from exports to the domestic production structure. To this end, both the number of controlled imports and the percentage of such items in total imports were increased after 1974.* These selective import substitution policies were balanced against the resistance of downstream producers who produced mainly for overseas markets, the small but growing resistance of domestic consumers to such protectionist policies, and the rapidly growing pressures from foreign governments, particularly the United States, for Taiwan to open its domestic markets. Overall trade policy remained export-oriented. Although it was not until June 1984 that significant moves were taken to accelerate liberalization of import controls, there has been a steady reduction in tariff rates since 1971.* Over time, the spread of tariff rates has narrowed, and the average tariff burden (total tariff revenue divided by total imports) has declined steadily.

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*S.C. Tsiang, Wen Lang Chen, and Alvin Hsieh, "Progress in Trade Liberalization, Taiwan, Republic of China," Economic Review (The International Commercial Bank of China, Taipei, Taiwan, March/April 1986), p. 8.

During the early 1980s, declines in economic growth rates, and stagnant domestic investment, coupled with an undervalued currency, resulted in massive trade surpluses; this created mounting pressure for import-liberalization. Recent industrial policy has been designed to shift from relatively unskilled labor-intensive industry toward higher skill and higher technology-intensive areas. Investment rules for foreign firms have been eased and the transfer of technology has been encouraged. Specific incentives include low-interest rate loans, extended income tax holidays, liberalized venture capital regulations, the formation of the Hsin Chu science park, and other steps to help expand the infrastructure for high-technology industries. Compared with South Korea, however, Taiwan continues to use more indirect incentives and fewer direct levers to influence economic development.

B. Role of Subsidies in Taiwan's Economic Policy**

As noted, a variety of subsidies played a significant role in the reorientation of policy from import-substitution to the promotion of exports. The first priority has been to offset the negative impact of import protection and indirect taxes on export costs. This has generally been achieved. Substantial subsidies are also provided, mainly in the form of income tax deductions, to firms in government targeted industries. These subsidies are paid even when the firms are not exporters, because they may still provide stimulation to exports. Consumer subsidies, especially the setting of prices for rice and other basic foods above world market levels, are few and require little budgetary funding. Government investment is large (above one-half of the total), but, apart from usual infrastructure projects, state-owned enterprises are expected to, and normally do, run a profit. At times, the government covers the losses of a state-owned firm in a key industry, such as steel, but such subsidies have been temporary and have not been a heavy burden on the budget.

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*The number of controlled import goods was dramatically reduced in 1971. To offset the effects of reduced controls, the government simultaneously increased tariff rates and also incorporated a temporary 30 percent surcharge into the permanent tariff schedule.

**Besides the more general sources noted above, the discussion of subsidies in the rest of this chapter also draws from United States International Trade Commission, Foreign Industrial Targeting and its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan (USITC Publication 1632, January 1985); 1984 Joint Conference on the Industrial Policies of the Republic of China and the Republic of Korea (Taipei: Chung-hua Institution for Economic Research, December 27-28, 1984); Industrial Policies of the Republic of Korea and the Republic of China (Seoul: Korea Development Institute, November 21-22, 1985); Kuo-shu Liang and Ching-ing Hou Liang, "Trade Strategy and Industrial Policy in Taiwan," Economic Review (September-October 1986), pp. 1-2; "Ninth Medium-Term Economic Development Plan for Taiwan (1986-1989)--External Sector," Economic Review (The International Commercial Banks of China: Taipei, Taiwan, January-February 1987), pp. 1-16.

Because Taiwan's currency more often than not has been undervalued, subsidies beyond the accepted reimbursement of indirect taxes and import duties affecting the cost of exports have not been necessary to sustain the rapid growth of exports.

With regard to industrial policy, the second oil shock and the recession of the early 1980s created pressures toward greater use of direct grants, loans, and provision of seed money for selected firms in the private sector. Six criteria were identified in the four year (1982-86) plan to determine which industries would receive priority treatment: 1) linkage to other major industries in Taiwan; 2) low energy intensity; 3) low pollution; 4) contribution to net exports; 5) high domestic value-added; and 6) technology-intensity. In addition, three strategic industries were identified: informatics, electronics, and machinery. The government committed itself both to direct investments in projects and to underwriting a variety of major research and development projects. With some changes in emphasis and greater attention to market liberalization, the Ninth Medium-Term Economic Development Plan (1986-89) continues this focus.

C. Types of Subsidies*

As the Taiwanese economy has developed and as the industrial priorities of the general economic strategy were changed, the specific incentives and subsidies introduced in the 1960s have been modified, adapted, or replaced. Taiwan's incentives contain instruments that are clear subsidies to exports or are targeted in such a way that they potentially fall under the specificity test in U.S. subsidy legislation.

1. Export Subsidies

Taiwan has agreed, in a bilateral exchange with the U.S., to comply with the Tokyo Round subsidies agreement on a multilateral basis. Most programs now conform with the code, but some are still questionable.

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*The annex provides more detail on specific programs as well as on the history of U.S. countervailing duty cases.

- Foreign Firm Incentives: Foreign firms account for a substantial share of Taiwan's exports, and in some industries they are the dominant exporters, most notably in electronics. The industrial specificity and the export requirements attached to some of the foreign direct investment incentives offered may in fact constitute subsidies, although they have not been cited in the CVD case history.

- Preferential Export Financing: Low cost (below market rate) loans may be applied for through authorized foreign-currency banks, under the Export Loan Discount Regulations of the Central Bank of China. (Found to be a subsidy in some cases.)

- The Export-Import Bank of China (founded in 1979) provides credit and credit guarantees for exports of plants and equipment and overseas construction projects. It also can underwrite imports of raw materials and technical services and provides export insurance. The terms of the loans appar generally to comply with OECD guidelines.

- Export Loss Reserves: A share of the previous year's export earnings can be used to offset export losses in the current year. Any excess over actual losses is carried forward as taxable income in the following year, which constitutes an interest-free loan, and therefore a subsidy.

- Business Tax Exemption and Stamp Tax Reductions for Export Sales: These indirect taxes are exempted or rebated on goods destined for export. The rebate has not been found to be excessive in CVD cases.

- Preferential Prices for Raw Materials and Manufactured Inputs: It has been alleged that some state-owned enterprises offer preferential pricing for exporters. In the welded carbon steel line pipe case, it was found that the China Steel Corporation's export prices were consistent with world market prices and therefore did not confer a subsidy.

- Preferential Income Tax Ceiling for Big Trading Companies: Trading companies that meet certain, annually determined, export levels and other criteria pay income tax at a 25 percent ceiling rather than the standard 35 percent; in principle, this is an export subsidy.

- Duty Drawback on Imported Inputs for Exports: Unless excessive, this is allowable under GATT and U.S. law. In the certain stainless steel cooking ware case the procedures used were found to provide an excessive drawback. In the same case, it was found that duty drawback was granted on some inputs not incorporated into exports, Both conferred a subsidy.

2. Domestic Subsidies

In an economy as export-oriented as the Taiwanese, the dividing line between domestic and export subsidies is thin indeed. Invariably, industrial policy merges into export policy.

- Tax Preferences: Tax policy has always been one of the most important forms of industrial policy used by the Taiwanese government. The present tax system provides incentives for production of high value-added goods. The income tax incentives are laid out in the Statute for the Encouragement of Investment, but the criteria for implementing these incentives are spelled out only in the implementing laws and are modified frequently to reflect changes in industrial policy and market conditions. Tax incentives are applied in two main ways:
    - The first provides case-by-case incentives to firms in specific industry segments. The main criterion is expectation of future competitiveness. Other criteria can include increasing export volume, achieving economies of scale, increasing domestic content, and upgrading production technology.
    - The second is used is through the designation of strategic industries. Unlike the more specific approach in which only a few firms may be eligible in a specific industry, this approach permits most firms in eligible industries to qualify for the incentives. The main types of tax incentives include: exemption from corporation income taxes (sometimes up to 9 years), accelerated depreciation, reduced income tax rates, and rebates or delays of import duties, transaction taxes, and various other charges and excise taxes.
- Financial Instruments: Although there has been some liberalization, the ROC government still tightly controls the financial system and strongly influences the flow of credit. In addition, several government financial institutions are directly charged with providing credit to targeted sectors of Taiwan's economy. Targeted economic development loans generally provide credit at commercial rates when such credit might not otherwise be available because of risk considerations. The general policy of maintaining positive real interest rates for savers and the commitment to sound management and financial policies result in a situation in which most of the government lending activities do not result in countervailable subsidies.
    - The Bank of Communications is the most important bank for industrial policy targeting. The Bank of Communications primarily extends concessional loans and credit guarantees to capital-intensive industries in the manufacturing, mining, transportation, and public utilities sectors. It also invests in new high-techology firms and provides a range of management assistance.

- A small and medium-size business credit guarantee fund was founded in 1974 to help smaller firms secure financing. This fund guarantees a variety of loans from other financial institutions, which includes export financing. The Channel Development Corporation (CDC) is a semiprivate trust company that also invests directly in targeted industries. It is only partially funded by government authorities, but still must take government industrial priorities into account when extending loans, loan guarantees, and equity investments in firms.

The aspect of Taiwan's industrial policy that is potentially troublesome is the tendency to target specific firms and industries for special treatment. However, the legislation is usually designed in such a way that firms have to meet certain criteria that are generally applicable. Part of the motivation for the type of legislation chosen is encouragement of the growth and merger of firms.*

D. Trade Disputes Involving Taiwanese Subsidies

Taiwan has faced ten countervailing cases in the United States since the mid-1970s. Footwear, handbags, textiles, and apparel were at issue in the 1970s; since 1980, the cases have focused almost exclusively on a variety of specific steel-based products. Most of the older cases are now closed, while the more recent ones have had negative final determinations or were dropped as part of the Voluntary Restraints Agreement with the United States on steel exports.

The incentive programs targeted in the CVD cases have included income tax incentives for exporters and concession of loans (Table X-2). Specific tax instruments most often identified were the export loss reserves, the tax exemption for export sales, the preferential income tax rate ceiling, the accelerated depreciation and tax holiday program, and the tax credit for investment in productive equipment. Other tax programs that have been investigated include various duty exemptions and deferrals on imported equipment. CVD cases also have usually identified preferential long-term loans and preferential export financing under the export-financing program for investigation.

Some of the various instruments in the past have been determined to confer subsidies, but, in general, ad valorem duties assessed on subsidies have been low or de minimis, the material injury investigation by the ITC was negative, or the program was dropped or modified by the ROC government. This history suggests that, although the somewhat detailed nature of Taiwan's incentive programs appears to contravene U.S. subsidies legislation, the rates of subsidization have been too low to constitute major problems. Indeed, the 1986 National Trade Estimate by the Office of the U.S. Trade

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*Many of the criteria are based on indicators of size, such as sales, total exports, gross investment, and capitalization.

Table X-2

TAIWANESE SUBSIDY PROGRAMS: U.S. INVESTIGATIONS

	Number of Times Cited	Number of Times Case and/or Program Found C.V.
Total # of Cases	10	7
Programs:		
Preferential Export Financing	4	4
Export Loss Reserves	4	3
Article 29	3	
Stamp Tax Reductions	2	
Preferential Prices for Raw Materials	2	
Preferential Income Tax Ceiling--25 Percent (Article 15)	6	4
Preferential Income Tax Ceiling--22 Percent (Article 15)	5	
Tax Credit for Investment in Production Equipment (Article 10)	3	
Accelerated Depreciation and Tax Holiday (Article 6)	4	
Duty Exemptions and Deferral on Imported Equipment (Article 21)	5	2
Preferential Long-Term Loans (Article 84)	4	
Vocational Training Center	1	

Sources: Office of the U.S. Trade Representative, Trade Action Monitoring System; and documentation obtained from the United States Department of Commerce's Central Records Information Management System.

Representative made no mention of subsidies as an issue in U.S.-Taiwan trade relations.

E. Impact of Taiwanese Subsidies

The impact of Taiwanese subsidies seems to be very similar to that for South Korea: it has largely been to offset the costs of high import protection on exporting firms and generally to bias the industrial structure towards manufacturing and international markets. Creation of extreme distortions and inefficiencies was largely avoided, and as import restrictions have been slowly liberalized and rationalized, the export incentives have also been reduced. Taiwan's effective rates of protection across major industry groups in the late 1970s are shown in Table X-3; with limited exceptions, the rates are low and the variation small, especially in manufacturing.

Moreover, the U.S. legislative history of countervailing duty cases against Taiwanese products has clearly shown that, although some countervailable subsidies have existed in recent years, Taiwan has largely complied with its bilateral agreement with the United States to apply the rights and obligations of the Tokyo Round of GATT negotiations on a most-favored-nation basis, including those of the subsidies code.

By most standards, Taiwan's subsidy policies have been extremely successful. They contributed to the creation of a market-oriented, high-growth industrial base that can produce a wide range of products at internationally competitive prices. The main distortions and domestic costs that have been created largely result from the structure and redundancy of the import protection system, rather than from the use of subsidies.

Table X-3

RATES OF PROTECTION IN TAIWAN

Name of Sector (I-O Code)		Nominal Protection Rate	Effective Protection Rate
Agriculture, Forestry & Fishing			
Polished Rice(1)		0	-1.9
Leaf Tobacco & Beverage Crops (8)		0.1	-7.0
Fishing (15)		6.6	1.8
Mining			
Iron Ores (18)		0.4	-3.7
Other Non-Ferrous Metal Ores[1](22)		0.2	-11.7
Manufacturing			
Dairy Products (29)		14.5	-13.3
Processed Sea Foods (31)		9.3	N
Sugar (35)		9.1	*
Cotton Yarn (43)	U	36.1	103.9
Cotton Fabrics (49)	U	36.1	58.7
Wool Fabrics (51)	U	31.1	65.7
Chemical Fibre Fabrics (53)	U	12.1	21.8
Plywood (62)	U	237.4	1,088.5
Paper (67)	U	8.0	7.2
Basic Petrochemical Products (70)	P,E^-	1.0	-74.6
Chemical Fertilizers (79)	P	7.5	12.6
Synthetic Resins (82)	P	5.2	*
Agricultural Chemicals (86)	P,E^+	9.0	21.4
Powder, Explosives & Pyrotechnic Products (89)	P	9.0	9.8
Rubber Products (93)	U	30.8	86.1
Pottery Products (94)	U	16.9	29.3
Cement (97)	U,E^-	257.4	*
Pig Iron (100)	P,E^-	9.7	42.5
Raw Steel (101)	P,E^-	9.7	14.2
Rolled Steel Products (102)	P	5.2	-33.3
Non-Ferrous Metal Ingots (105)	P,E^-	10.8	15.1
Prime Movers (111)	T	1.3	-37.0
Agricultural Machinery (112)	T,E^+	1.3	-44.4
Metal-Working & Woodworking Machinery (113)	T	1.3	*
Household Electric Appliances (117)	T,E^+	21.8	44.0
Electrical Industrial Apparatus (118)	T	9.5	*
Household Electronic Appliances (120)	T,E^+	5.1	-34.4

Name of Sector	National Protection Rate		Effective Protection Rate
Communication Equipment	T	5.1	-21.7
Electronic Components (123)	T,E^+	5.1	-8.5
Ships (124)	S	4.0	-0.3
Motor Vehicles (126)	S,E^+	21.4	322.3
Measuring, Medical & Optical Instruments (128)	S	3.4	*
Watches & Clocks (129)	S	3.4	-11.5

Notes:
1) Including oil and LNG.
2) Including tobacco products.
3) Including aluminum
4) N; excluded due to the sector's value added per unit prices being negative (W^c 0).
5) *; excluded due to the sector's value added per unit in domestic prices being negative (V^c 0).
6) In case of W^c 0, V^c 0 and $W^c - V^c$ 0, EPRs have a negative sign.
7) NPR; nominal protection rate defined as the implicit tariff calculated as the price differential between domestic and foreign market. When such data are not available it is defined as the ratio of total import duties and the C.I.F. import values.

EPR; effective protection rate defined as the proportionate increment in value added per unit level of an activity brought about by the tariff structure over its free trade value added, i.e. a weighted average of its nominal protection and the protection of its inputs, calculated using nominal protection calculated as above.

Unskilled Labor Intensive Industry (U): Those industries whose skilled labor ratio (wage earned by skilled laborer/total wage) is less than 0.4 are defined as unskilled labor intensive industries.

Skilled Labor Intensive Industry (S): It designates those industries whose skilled labor ratio is more than or equal to 0.4

Capital Intensive Industry (P): Those industries whose capital intensive [(total value-added--compensation of employees--indirect taxes)/number of employee] is more than or equal to 0.8.

Technology Intensive Industry (T): Those industries whose technology intensive (compensation of skilled employees/numbers of employee) is more than or equal to 0.5.

Energy Intensive Industry E^-: Those industries whose energy intensity (total input coefficient of energy/total input coefficient) is more than or equal to 0.2.

Less Energy Intensive Industry (E^+): Those industries whose energy intensity is less than 0.05.

Source: Hak Yong Rhee, "Protection Structure of the Developing Countries in South and East Asia," (Unpublished paper, Korean University. Presented at the Pacific Cooperation Task Force Workshop on Trade in Manufactured Goods, Seoul, South Korea (June 28-30, 1983), pp. 14-16.

XI. CONCLUSIONS AND POLICY IMPLICATIONS

A. The Use of Subsidies in the Eight Selected LDCs: Some Similarities and Differences

The use of subsidies in the eight subject countries tends to reflect their differences in size and structure, as well as differences in the peoples' and governments' political objectives. In particular, the degree to which governments have been willing to subordinate other objectives rapid economic growth was an important factor determining the thrust of their economic and trade policy. Also important is the extent to which governments have felt it necessary to intervene in or to control economic activity.

At one end of the spectrum, Hong Kong's laissez faire policy approach essentially precluded the use of subsidies, except in one or two rather special cases. In Singapore, the government has taken an active role in guiding economic development and, as part of this role, has provided sometimes powerful inducements to firms to develop more sophisticated production for export. The government did not try to cover either operating costs or capital costs, but rather levied lower rates of taxation on firms in favored industries. Nevertheless, the fact that industrial incentives are highly targeted make Singapore vulnerable to countervailing duty suits.

In South Korea and Taiwan, subsidies have been designed mainly to offset the negative impact of tariffs and other forms of import protection on the costs of exporters. Although such subsidies are allowable in principle under GATT guidelines and U.S. law, in practice, the various rebates were numerous and complex enough to go occasionally beyond allowable limits. Both countries have provided strong inducements to develop modern industrial sectors, including access to favorable financing and tax concessions.

India, and to a lesser extent Indonesia, have used subsidies for a wide range of domestic purposes and have subsidized exports mainly to offset some of the disadvantages that distortions in the domestic price system created for exporters. Because neither country exports a large volume of manufactures (other than textiles and clothing) to the industrial West, they have not been involved in serious trade disputes.

Brazil and Mexico have both made heavy use of subsidies for internal purposes; in addition, they have subsidized exports heavily over long periods to compensate for overvalued currencies. It is the latter practice that has been the principal source of the many trade disputes and countervailing duty cases involving both countries.

In general, it is clear that export subsidies have been used not so much to promote exports, as to compensate for either the negative impact of import restrictions, domestic taxes, or overvalued curencies. There have been instances of subsidies which aided exports even though exporters had no disadvantages to overcome, but such cases are few. The best evidence of this general point comes from the estimates of net protection by industry in several LDCs. These indicate that the domestic price level in most industries was above the world market price level.

B. Impact of Subsidies on Economic Performance

For reasons just described, it is not possible to distinguish the impact on economic performance of subsidies specifically from that of the entire system of taxes, controls, and duties, which affect relative prices and costs. The net effects of all these government interventions can be measured in terms of differences between domestic and world market price levels, what the World Bank calls an economic distortion index. In its 1983 annual report, the World Bank showed that there was a clear inverse correlation between the degree of distortion in a country's prices and its economic performance--the higher the degree of distortion, the slower the rate of economic growth, and the higher the rate of inflation.* In this study, South Korea is classified as a relatively low distortion country; it has experienced a very high rate of growth. India, Indonesia, Brazil, and Mexico were classified as moderate distortion countries; they have experienced medium-to-high rates of economic growth. Taiwan, Hong Kong, and Singapore were not treated in the World Bank study, but they clearly fit into the low-distortion group; and all have experienced very high growth.

Underlying these relationships are fundamental policy differences among the countries studied. Even though South Korea and Taiwan have sustained fairly high levels of protection, the government has not intervened directly in the bulk of domestic economic activity, relying more on guidance. More important, both countries, as well as Hong Kong and Singapore, have sustained competitive exchange rates except for relatively short periods. (This is the main reason that their distortion index has been low.) The long periods of overvalued currency in Brazil and Mexico created distortions as well as severe swings in economic activity--intense economic booms followed by severe recessions due to stabilization programs. These cycles undoubtedly resulted in slower average growth over the entire period than would have been the case if economic policies had been more stable.

C. Political Aspects

Apart from judging the impact of subsidies as aspects or consequences of broader sets of economic policies, it is legitimate to consider what might have been the outcome if the option of applying subsidies had not been available to the LDC governments. We can address only export subsidies, however, because evaluations of subsidies with essentially domestic objectives would require far more thorough analysis of domestic economic, social, and political problems than is possible in this study.

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*World Bank, World Development Report, 1983, pp. 60-61.

It is clear that export subsidies enabled many of the subject LDCs to sustain levels of import protection, and especially overvalued currencies, longer than would otherwise have been the case. It is unlikely, for example, that Brazil would have been able to postpone its debt crisis until 1983 if it had not subsidized exports in the face of a highly overvalued currency. Brazilian export growth in the late 1970s and early 1980s would have been substantially less, and either foreign bankers would have been less willing to provide loans or the debt crisis would have occurred earlier. In effect, by subsidizing exports, Brazil was postponing adjustment. To some extent, this was true of some other countries; Brazil is an extreme case.

A related question is the impact of U.S. pressure to eliminate subsidies on the economic policy of the subject countries. The effectiveness of such pressure is clearly in direct proportion to the dependence of the country on trade with the United States. Taiwan and South Korea are prepared to bend fairly readily to U.S. pressure, because they feel they have no alternative, given their high dependence on the U.S. market. U.S. leverage on Mexico is fairly substantial, although much less than for the two countries just mentioned. In the case of India and Indonesia U.S. leverage is minimal. In the case of Brazil, U.S. leverage is small; on the one hand, Brazilians believe they can achieve rapid growth mainly by developing the domestic market; on the other hand, they also realize both that they must expand exports rapidly to service their debt and that export expansion is important to increased efficiency in the long-term.

Finally, it is evident that the elaborate U.S. process of investigating the many intricacies of taxes and prices in the subject countries in order to determine whether countervailable subsidies exist is a source of great irritation for the governments and business communities concerned. While both groups can readily understand that a country might want to protect its domestic producers against a large import incursion, they clearly resent what they view as an attempt to apply American criteria to the operation of their own economic system. Moreover, responses to U.S. demands for evidence pertinent to CVD cases place a heavy burden on the bureaucracy in question. If new U.S. trade legislation should further broaden the criteria for "unfair trade" cases, the level of irritation in some countries could reach the point where U.S. pressure for trade liberalization becomes counterproductive.

D. Policy Implications

Although this study does not, strictly speaking, address U.S. policy issues, its findings have implications for the general U.S. approach to Third World countries on subsidies. A strong case can be made that these countries should, in their own interest, reduce the use of subsidies. By and large, the prevalence of subsidies is a direct reflection of distortions in a country's price/cost system. In general, these distortions result mainly from overvalued currencies, high rates of protection from imports, and direct government controls. Countries with highly distorted price structures have generally experienced relatively poor economic performance. Actions to reduce the price distortions, such as currency depreciation and trade and internal liberalization, make it possible to reduce subsidies as well.

There has been a clear global trend, including in Third World countries, to recognize the high costs of price distortions and excessive government intervention in economic processes. Although foreign exchange and budgetary constraints, as well as remaining economic nationalism, have severely constrained liberalization in some countries, including Indonesia and Brazil, some countries, notably India, have taken major steps, and others, including South Korea, Taiwan, and Mexico, have reduced their dependence on government controls.

Beyond the LDCs changing perceptions of their own interests, U.S. pressure has contributed to the trend toward economic liberalization and can do so in the future. There is also little doubt that the threat or reality of CVD actions at times has been an effective form of U.S. pressure. It is important, however, to be sensitive to the risk that increasingly elaborate CVD investigations will be viewed as unwarranted interference in a country's domestic economic affairs, and therefore become counterproductive.

GATT'S LIST OF EXPORT SUBSIDIES

ANNEX A

GATT'S LIST OF EXPORT SUBSIDIES

The following list is an annex to the GATT Code on subsidies and countervailing duties which was drafted at the 1979 Tokyo Round Multilateral Trade Negotiations. The list consists of export subsidies considered by GATT to be "potentially troublesome" and liable to countermeasures.

(a) The provision by governments of direct subsidies to a firm or an industry contingent upon export performance.

(b) Currency retention schemes or any similar practices which involve a bonus on exports.

(c) Internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipments.

(d) The delivery by governments or their agencies of imported or domestic products or services for use in the production of exported goods, on terms or conditions more favourable than for delivery of like or directly competitive products or services for use in the production of goods for domestic consumption, if (in the case of products) such terms or conditions are more favourable than those commercially available on world markets to their exporters.[2]

(e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes[1] or social welfare charges paid or payable by industrial or commercial enterprises.[2]

(f) The allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged.

(g) The exemption or remission in respect of the production and distribution of exported products, of indirect taxes[1] in excess of those levied in respect to the production and distribution of like products when sold for domestic consumption.

(h) The exemption, remission or deferral of prior stage cumulative indirect taxes[1] on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior stage cumulative indirect taxes are levied on goods that are physically incorporated (making normal allowance for waste) in the exported product.[3]

(i) The remission or drawback of import charges[1] in excess of those levied on imported goods that are physically incorporated (making normal allowance for waste) in the exported product; provided, however, that in particular cases a firm may use a quantity of home market goods equal to, and having the same quality and characteristics as, the imported goods as a substitute for them in order to benefit from this provision if the import and the corresponding export operations both occur within a reasonable time period, normally not to exceed two years.

(j) The provision by governments (or special institutions controlled by governments) of export credit guarantees or insurance programmes, of insurance or guarantee programmes against increases in the costs of exported products[4] or of exchange risk programmes, at premium rates, which are manifestly inadequate to cover the long-term operating costs and losses of the programmes.[5]

(k) The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of export credits at rates below those which they actually have to pay for the funds so employed (or would have to pay if they borrowed on international capital markets in order to obtain funds of the same maturity and denominated in the same currency as the export credit), or the payment by them of all or part of the costs incurred by exporters or financial institutions in obtaining credits, in so far as they are used to secure a material advantage in the field of export credit terms

Provided, however, that if a signatory is a party to an international undertaking on official export credits to which at least twelve original signatories to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original signatories), or if in practice a signatory applies the interest rates provisions of the relevant undertaking, an export credit practice which is in conformity with those provisions shall not be considered an export subsidy prohibited by this Agreement.

(l) Any other charge on the public account constituting an export subsidy in the sense of Article XVI of the General Agreement.

Notes

1. For the purpose of this Agreement:

The term "direct taxes" shall mean taxes on wages, profits, interest, rents, royalties, and all other forms of income, and taxes on the ownership of real property;

The term "import charges" shall mean tariffs, duties, and other fiscal charges not elsewhere enumerated in this note that are levied on imports;

The term "indirect taxes" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;

"Prior stage" indirect taxes are those levied on goods or services used directly or indirectly in making the product;

"Cumulative" indirect taxes are multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of the production are used in a succeeding stage of production;

"Remission" of taxes includes the refund or rebate of taxes.

2. The signatories recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The signatories further recognize that nothing in this text prejudges the disposition by the contracting parties of the specific issues raised in GATT document L/4422. The signatories reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any signatory may draw the attention of another signatory to administrative or other practices which may contravene this principle and which result in a significant saving or direct taxes in export transactions. In such circumstances the signatories shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of signatories under the General Agreement, including the right of consultation created in the preceding sentence.

Paragraph (e) is not intended to limit a signatory from taking measures to avoid the double taxation of foreign source income earned by its enterprises of the enterprises of another signatory.

Where measures incompatible with the provisions of paragraph (e) exist, and where major practical difficulties stand in the way of the signatory concerned bringing such measures promptly into conformity with the Agreement, the signatory concerned shall, without prejudice to the rights of other signatories under the General Agreement or this Agreement, examine methods of bringing these measures into conformity within a reasonable period of time.

In this connection the European Economic Community has declared that Ireland intends to withdraw by 1 January 1981 its system of preferential tax measures related to exports, provided for under the Corporation Tax Act of 1976, whilst continuing nevertheless to honour legally binding commitments entered into during the lifetime of this system.

3. Paragraph (h) does not apply to value-added tax systems and border-tax adjustment in lieu thereof; the problem of the excessive remission of value-added taxes is exclusively covered by paragraph (g).

4. The signatories agree that nothing in this paragraph shall prejudge or influence the deliberations of the panel established by the GATT Council on 6 June 1978 (C/M/126).

5. In evaluating the long-term adequacy of premium rates, costs, and losses of insurance programmes, in principle only such contracts shall be taken into account that were concluded after the date of entry into force of this Agreement.

Source: The Tokyo Round of Multilateral Trade Negotiations. Code on Subsidies and Countervailing Duties, Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade. Article 19, Part VII, Annex, April 1979, Geneva.

DOMESTIC PRACTICES CONCLUSIVELY CONSIDERED TO BE SUBSIDIES UNDER U.S. LAW

ANNEX B

DOMESTIC PRACTICES CONCLUSIVELY CONSIDERED TO BE SUBSIDIES UNDER U.S. LAW

The following domestic subsidies, if provided or required by government action to a specific enterprise or industry, or group of enterprises or industries, whether publicly or privately owned, and whether paid or bestowed directly or indirectly on the manufacture, production or export of any class or kind of merchandise:

(i) The provision of capital, loans or loan guarantees on terms inconsistent with commercial considerations.

(ii) The provision of goods or services at preferential rates.

(iii) The grant of funds or forgiveness of debt to cover operating losses sustained by a specific industry.

(iv) The assumption of any costs or expenses of manufacture, production or distribution.

Note: The provision that provides this enhanced definition of subsidies also contained the so-called specificity test, in that only programs with limited availability to specific firms or industries were defined as actionable subsidies.

Source: Tariff Act of 1930 as amended by the Trade Agreements Act of 1979 as quoted in Hans-Michael Giesen, "Upstream Subsidies: Policy and Enforcement Questions After the Trade and Tariff Act of 1984," *Law and Policy in International Business*, Vol. 17 (1985), pp. 250-251.

BRAZIL'S EXPORT AND DOMESTIC INCENTIVE PROGRAMS

ANNEX C

I. EXPORT INCENTIVES

A. Financial Instruments

1. Resolution 674--Working Capital Financing[1] (As of January 1984, the resolution number has been changed to 883)

This program, established in 1981 and administered by the Banco do Brasil, was one of the most important programs for providing short-term working capital for the purchase of inputs of manufactured exports. Traditionally, footwear and textile manufacturers relied heavily on this source of funding for their working capital needs.

Eligibility for Resolution 674 financing was based on the company's past export performance or on an acceptable export plan. The amount of financing was based on the dollar value of exports.

Following approval by the Banco do Brasil of an application, a participant in the program received certificates representing portions of the total approved amount. The certificates could be presented to banks in return for cruzeiros at the exchange rate in effect on the date of presentation. The certificates had to be used within 12 months of the date of issue, and loans incurred were to be repaid within 18 months.

Exporters could receive financing that ranged from as low as 12 percent to as high as 40 percent of the export value. Loans were available for up to 360 days and were exempt from the IOF tax (a tax on financial operations which amounted to 0.5 percent monthly).

In January 1984, many changes took place--the amount of funds available was reduced considerably and eliminated for some sectors (such as frozen concentrate orange juice); and the interest rate was changed to correct for inflation. At present, exporters arrange credit through a commercial bank at the "free market rate." The government then grants a direct interest rate subsidy to make the rate equal to the rate of inflation plus 10 percent.

The International Trade Administration (ITA) of the Department of Commerce determined that Resolution 674 was countervailable because it was available to a narrow group of producers.

2. Resolution 643--Incentives for Trading Companies (changed to Resolution 882 in 1984)

Resolution 643 provides the same financial benefits as Resolution 674. The only difference is that Resolution 643 is intended for trading companies only. Resolution 643 is also administered by Carteira do Comercio Exterior (CACES) of the Banco do Brasil and is determined by the ITA to confer a subsidy.

3. CIC-CREGE 14-11--Export Financing[2]

CIC-CREGE 14-11 complements Resolution 674. Under CIC-CREGE 14-11, the Banco do Brasil provides 180 and 360 days cruzeiro loans at below commercial rates for export financing. The only stipulation is that these companies must negotiate fixed-level exchange contracts with the bank.

To be eligible for this program, the exporter must manufacture products with a product cycle of less than 180 days and have previous export experience.

The ITA has determined that this program is countervailable as the interest rate is below the commercial rate and is not "generally available" to all manufacturers.

4. Resolution 68--Export Financing Fund (FINEX)

FINEX is an export financing fund operated by CACEX through the Central Bank. U.S. dollar financing is provided either directly through the Banco do Brasil or indirectly through private banks. Foreign buyers of Brazilian goods as well as exporters are eligible for the program. The foreign buyer, however, must demonstrate that he has paid at least 15 percent of the invoice price.

In 1984, approximately $2.7 billion was budgeted for FINEX. Capital goods received most of this financing. FINEX also funded overseas promotional and marketing activities, including defraying some of the costs of advertising, participation in trade fairs, and foreign market research.[3]

The ITA determines that this program is countervailable, as it benefits a select group of manufacturers.

5. Communication 331--Export Financing

Communication 331 is a set of rules and regulations established by the Brazilian government to govern foreign exchange contracts for export transactions. Banks are then responsible for acting as intermediaries in export transactions. Under Communication 331, the Central Bank of Brazil offers loans for up to 180 days against either foreign exchange contracts or foreign exchange receivables.[4]

Despite the accusation of many petitioners that the interest rates charged for loans under Communication 331 are below market rates, the U.S. Department of Commerce determined that this program did not confer a bounty or grant.

6. Resolution 330--Preferential Financing

Resolution 330 provides financing for up to 80 percent of the value of the merchandise placed in a specified bonded warehouse and destined for export.

The ITA has no formal position on this program, as all firms investigated for allegedly using this subsidy were found not to use it.

7. PROEX and PROSIM[5]

In 1983, the Economic and Social Development Bank (BNDES) established PROEX and PROSIM to increase exports.

PROEX provides short-term financing for Brazilian investors for equipment purchases, technical innovations, commercial promotion, and working capital.

PROSIM offers investment capital for the manufacture of import substitutes.

Firms receiving credits from PROEX and PROSIM have 5 years to repay the loan with a 2-year grace period. The interest rate is 10 percent above the rate of inflation.

Neither program lent any money in 1983 and both failed to disburse the full amount of their 1984 benefits.

Neither program was used by any of the Brazilian firms investigated by the ITA; therefore the ITA does not have an official position regarding this program.

B. Fiscal Instruments

1. Tax on Manufactured Products (IPI)* Program

a) IPI - Export Credit Premium[6]

One of the most important export incentives is the IPI export credits that have existed in various forms since 1969. Under the old program, the exporter received a credit that exceeded the indirect taxes that otherwise would have been borne by the exported product and its components. This additional credit could be used for payment of other federal and state taxes or transferred to other companies. In special cases, it could also be traded in for cash.

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*Industrial Product Tax (Imposto sobre Productus Industrializados).

When Brazil subscribed to the GATT subsidy code, it committed itself to eliminate these tax credits gradually according to a timetable that established June 30, 1983 as the final expiration date. However, in December 1979, this program was abolished completely in combination with the maxi devaluation of the cruzeiro. Due to Brazil's exchange rate policy and the appreciation of the U.S. dollar, the Brazilian government reintroduced the program on April 1, 1981. This program was not opposed by the United States, since it included a timetable for its gradual elimination.

The timetable was as follows: 15 percent through 30 March 1982; 14, 12.5 and 11 percent in the second, third, and fourth quarters of 1982 respectively; and three percent during the first quarter of 1983. The export tax premium rate was reduced to 9 percent in November 1984, 5 percent in January 1985, and 2 percent in April 1985.

In 1985, the government of Brazil introduced a new export credit premium that is granted to all sectors at a uniform rate. This tax credit takes the form of a cash reimbursement from the government, based on the "adjusted" f.o.b. value of the exported merchandise.

In order to receive the maximum credit premium, the exporter must demonstrate that 75 percent of the added value of the merchandise originated in Brazil. If this condition is not met, the f.o.b. invoice price is reduced only by the value of the imported inputs.

Since the export incentive does not consist of an over rebate of tax, and the program is available to all exporters, the ITA claims this program is, as it stands today, not countervailable. It was, however, determined to confer a bounty in its previous form.

b) IPI Rebates for Capital Investment[7]

The IPI Rebate for capital investment was instituted in April 1977, under Decree Law 1547, to provide funding for the expansion of Brazilian industry through a rebate of the IPI. Under this tax system, a company determines its liability for the tax at the end of each month. The net tax owed is calculated as the difference between the total IPI the company paid on purchases and the total IPI it collected on domestic sales. Usually, within five months after the end of each month, a company must pay the amount of the net tax owed directly to the Brazilian government. This net IPI tax is the basis for calculating the rebate for investment. A Brazilian steel company may deposit 95 percent of the net IPI tax in a special account with Banco do Brasil. The amounts deposited are to be applied to steel expansion projects, and, when rebated to the firms, constitute tax-free capital reserves that must eventually be converted into subscribed capital.

This program is only available to the steel sector, the ITA therefore determined that this benefit is countervailable.

2. Income Tax Exemptions for Export Earnings[8]

Under Decree-Laws 1158 and 1721, exporters of certain heavy iron construction castings are eligible for an exemption from income tax on a portion of their export revenue.

Because this exemption is tied to exports and is not available for domestic sales, the ITA determined that this exemption confers an export subsidy.

3. Accelerated Depreciation for Brazilian-Made Capital Equipment[9]

Pursuant to Decree-Law 1137, any company that purchases Brazilian made capital equipment and has an expansion project approved by the Council of Industrial Development (CDI) may depreciate this equipment at twice the rate normally permitted under Brazilian tax laws. While this program is available to all companies, firms can obtain approval only if projects meet at least one of several national interest criteria, including development of certain regions of the country.

The ITA declared this program countervailable, because project approval is discretionary and not generally available on equal terms.

4. The Commission for the Granting of Fiscal Benefits for Special Export Programs (BEFIEX)[10]

The BEFIEX program was established in 1972 by the Brazilian Government to promote exports of manufactured products by granting fiscal incentives to imports, facilitating the growth and modernization of enterprises and/or the diversifiction of production lines. BEFIEX plays an important role in encouraging multinational companies to operate at economic scales, attaining specialization of production, and contributing to the modernization of Brazil's production apparatus. Companies negotiate an agreement with the government in exchange for tax benefits. This contract covers the export commitment of the company, the level of imports, amount of domestic value-added content, additional investments to be made by the company, and the net foreign exchange earnings for Brazil.

Among the special incentives granted by BEFIEX are the following:

a) A 70 to 90 percent tax reduction on imported machinery, equipment, and tools necessary to meet the approved export commitment;

b) An extension of the period for carrying tax losses forward from four to six years;

c) Amortization of pre-operational expenses of BEFIEX projects at the discretion of the company rather than the normal straight-line amortization over ten years;

d) Maintenance of fiscal export incentives during the entire period of the export program. This condition has been very important especially since fiscal credits were abolished in 1979 and then reintroduced in 1982. These changes did not affect the fiscal credits granted to enterprises joining the BEFIEX program before March 30, 1982.

e) A 50 percent duty and tax reductions on imports of raw materials, components, and intermediate product imports, up to a total import value of one-third of the average met f.o.b. value of exports.

Between 1981 and 1983, 147 contracts were signed committing companies to exports of manufactured products worth $145 U.S dollars. The largest single recipient of BEFIEX subsidies has been the automobile industry. Combined, the auto parts makers and automobile manufacturers have committed themselves to 35 percent of BEFIEX's total commitment.

The ITA determined that BEFIEX confers a bounty or grant and is therefore countervailable.

5. Council of Industrial Development (CDI) Programs[11]

CDI is one of the principal agencies used by the government to control investments. This agency is responsible for awarding tax incentives and tax exemptions on imported products and equipment, and for facilitating financing arrangements to approved industries. Most CDI incentives do not require an export agreement, and they are usually directed to Brazilian-owned firms.

The CDI incentive package can include:

a) An exemption of 80 percent of customs duties and 80 percent of the IPI tax on certain imported machinery;

b) Reduced border taxes on imports;

c) A waiver of prior deposit on imports;

d) Access to official subsidized credits; and

e) Allowance of accelerated depreciation for domestic capital equipment.

The CDI incentive program was reduced substantially in 1979, in an effort to raise government revenues. In 1983, CDI approved 78 projects for CDI investments. Eighty percent of CDI-approved instruments were targeted to basic and intermediate metal products, chemicals, petrochemicals and pharmaceuticals. Fiscal incentives, including tariff reductions and CDI tax reductions, were limited to chemical and nonmetal intermediate product sectors.

The ITA argues that CDI incentives are countervailable, since they are limited to "approved" development projects.

6. Commission for Export Incentives--CIEX[12]

CIEX was established in December 1975 to promote exports. It is operated by BEFIEX, and its tax incentives are available for small enterprises reluctant to make long-term export commitments. Under CIEX, import duties and taxes are reduced by 90 percent for machinery and equipment used for manufactured exports. An export agreement usually lasts for five years, and the export targets compared with the import volume are lower than in the BEFIEX program. CIEX is only about 10 percent the size of BEFIEX.

The Department of Commerce maintains that CIEX is countervailable because it is offered to a selective group of producers.

7. State Value-Added Tax (Imposto Sobre Circulacao de Mercadorias) ICM Export Credit Premium[13]

Prior to 1979, Brazilian companies were eligible for an over rebate of a state value-added tax on goods destined for export. This program was eliminated in January 1979 in combination with the maxi devaluation of the cruzeiro. Currently, exporters of manufactured goods are exempt from the state value-added tax.

The ITA determined that the exemption of indirect taxes levied on the value added on exported goods does not constitute a countervailable benefit.

C. Other Instruments

1. Resolution 643--Incentives for Trading Companies[14]

CACEX, the trade department of the Banco do Brasil, offers eligible trading companies preferential loan agreements. Eligible firms have access to a line of credit that can be drawn down to purchase goods for export. The trading companies use the loan principal as advance payment for the goods purchased. These loans are subject to the same interest constraints as Resolution 674 loans. Normally, the term of the loan is not to exceed 180 days, but the actual length varies, running from the date of receipt of the loan to the date of shipment of the goods. The interest is paid in full at the end of the loan term.

Because this incentive is not generally available, the ITA determines that this program is countervailable.

2. Resolution 588--Government Assistance in Repaying Foreign Loans[15]

Resolution 588 is one of several measures designed to deal with Brazil's overall hard currency debt problems. It is available to all companies unable to meet scheduled payments on government guaranteed direct dollar debt. Under the program, the Banco do Brasil assumes payments owed to overseas lenders with funds provided by the Central Bank. The assumed payments are converted into cruzeiro loans from the Banco do Brasil to the companies.

The ITA determines that Resolution 588 is noncountervailable, because the program is available to any company.

II. DOMESTIC INCENTIVES

A. Financial Instruments

The Brazilian banking system is comprised of four main federal banks: the Central Bank (BACEN), the Banco do Brasil (BB), the National Economic and Social Development Bank (BNDES), and the National Housing Bank (BNH). BACEN, BNDES, and BNH channel funds to commercial, regional, development, and investment banks for lending to customers.

Banco do Brasil is the largest commercial bank in Brazil (representing 17 percent of all cash deposits in 1981) and the government's main lending agency. Its activities are directed primarily to agriculture, exports, and energy.

BNDES is the major financial agent for the Brazilian government's industrial investment policy. Under this institution, there are three branches--BNDES, FINAME, and BNDESPAR. The three primary objectives of these financial institutions are to promote economic and social development, reduce regional income differences, and to strengthen Brazilian-owned private companies.

A few domestic incentive programs offered by BNDES warrant discussion.[16]

1. BNDES

The largest lending division of BNDES is called BNDES. It accounted for over half of all lending disbursements in 1983. Most of these funds went to large companies in the steel, electricity, and infrastructure sectors.

Through BNDES companies owned by Brazilian nationals may receive long-term financing in cruzados (usually at interest rates set at 12 percent above the rate of inflation) for the purchase of capital equipment and expansion projects.

These loans are available to private as well as state-controlled enterprises for a maximum of 20 years, and require an analysis of the economic viability of the project and the ability of the borrower to service the debt.

The ITA determines that BNDES loans do not confer a subsidy, because they are available to a broad range of economic sectors.

2. Special Agency for Industrial Financing (FINAME)

FINAME, a subsidiary of BNDES, provides long-term cruzado financing for the purchase of capital equipment manufactured in Brazil. The equipment financed must have high domestic-made content, usually around 80 percent.

FINAME loans are offered to a broad range of industries, and even foreign-owned companies are eligible for financing. Loans are extended for 18 to 36 months and carry an interest rate 6 to 12 percent above the rate of inflation.

The major recipients of FINAME financing in 1983 were steel, electricity, and infrastructure.

Because FINAME loans are available to a variety of different sectors, the ITA maintains that FINAME loans do not confer a bounty.

3. BNDES Participations, S.A. (BNDESPAR)

BNDESPAR, another BNDES subsidiary, purchases stock for minority ownership of Brazilian-owned companies. In late 1983, BNDESPAR investments were channelled to nonferrous metals, chemicals, steel, and paper industries.

The ITA consistently holds that government provision of, or assistance in, obtaining capital does not per se confer a subsidy. Government equity purchases or financial backing bestow a countervailable benefit only when provided on terms "inconsistent with commercial considerations." Commercial considerations are a company's current and future ability to earn a reasonable rate of return on equity investments.

B. Fiscal Instruments

1. Accelerated Depreciation

The government of Brazil allows any company that purchases Brazilian-made capital equipment and has an expansion project approved by the CDI to depreciate this equipment at twice the rate normally permitted under Brazilian tax laws.

2. Superintendencia de Desenovolvimento do Nordeste (SUDENE)

SUDENE, a government agency, extends tax credits, exemptions, and other benefits operating or investing in the northeast of Brazil.

This program was investigated for the U.S. countervailing case involving ethanol fuel. Since none of the companies investigated were located in the northeast, the ITA did not make a formal decision regarding this program.

3. Cost Equalization Program

Under this program, the Instituto do Agucar e do Alcool (IAA), a government lending agency, makes cash payments to fuel ethanol producers located in the states of Alagoas, Epirito Santo, Minas Gerais, Paraiba, Pernamboco, Rio de Janeiro, and others.

This program was not used by any of the ethanol producers investigated by the ITA. Therefore, the ITA did not make an official statement regarding this program.

C. Other Instruments

1. PROALCOOL Industrial Credit

The PROALCOOL program, administered by the Commissao Nacional Executiva do Alcool (CENAC), offers long-term financing at preferential rates for the construction, expansion, and modernization of ethanol production and storage facilities.

Projects eligible for PROALCOOL financing include:

- establishment, expansion, or modernization of a distillery;
- installation of an agricultural storage facility;
- production of raw materials for use in ethanol production;
- research and support for the production of raw materials;
- innovation and improvement of the technology related to the production and use of ethanol; and
- irrigation.

Private companies that wish to produce ethanol must submit a project plan to CENAL for approval. Approval of the plan is usually contingent on the location and dimension of the project.

Once a project is approved, the producer is eligible for:

a) PROALCOOL credit lines administered by the Banco do Brasil to finance the start-up costs; and

b) PROALCOOL long-term investment loans, that are to be paid back according to amortization schedules linked to the expected development of production.

The maximum level of eligibility has varied, depending on the category of borrower and the year in which the loan was taken out. The interest rates have also varied, depending on the year in which the loan was taken out.

The ITA determined that this program was countervailable, because PROALCOOL industrial credits are limited to a specific industry or group of industries, and provide funds to borrowers at interest rates lower than those available from commerical sources.

2. Programa Nacional de Melhoramento da Cana-de-Acucar (PLANALSUCAR)

Under the aegis of PROALCOOL, the government of Brazil provides research and development assistance aimed primarily at increasing the saccharose content of sugar cane, developing higher-yield and disease resistant strains of sugar cane, and increasing the productivity of Brazilian distilleries.

The ITA argues that this program is not countervailable, as it is available to all agriculture sectors under different programs.

3. Labor Programs for Employees of State Enterprises

The government of Brazil provides restricted fringe benefits and pay levels for public employees.

This subsidy was investigated only once by the ITA. As the alleged user had not taken advantage of the incentive, the ITA did not adopt an official position on this incentive.

BRAZILIAN COUNTERVAILABLE SUBSIDY PROGRAMS UNDER U.S. LAW

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Accelerated Depreciation	1982	Prestressed Concrete Steel Wire Strand	0.32
	1983	Certain Stainless Steel Products	0.03
		Certain Steel Tools	0.17
BEFIEX	1985	Non-rubber Footwear	0.04
		Cast Iron Pipe Fittings	0.50
CDI	1983	Certain Stainless Steel Products	0.18
		Certain Steel Tools	0.02
	1984	Certain Carbon Steel Products	0.45 0.37 0.22
	1985	Cast Iron Pipe Fittings	0.38
CIC-CREGE 14-11--Export Financing	1983	Certain Castor Oil Products	0.02
	1984	Certain Carbon Steel Products	0.33 0.79
		Oil Country Tubular Goods	0.38 1.04

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
	1985	Non-rubber Footwear	0.55
		Cast Iron Pipe Fittings	2.40
		Agricultural Tillage Tools	1.78
CIEX	1985	Non-rubber Footwear	0.05
		Cast Iron Pipe Fittings	0.25
FINEP - Long Term Loans Under ADTEN	1985	Cast Iron Pipe Fittings	0.26
		Agricultural Tillage Tools	0.001
Government Equity Infusion	1984	Certain Carbon Steel Products	20.36 24.5 3.73
Government Guarantees on Long-Term Loans	1984	Certain Carbon Steel Products	0.20 0.37 0.60
IAA	1985	Ethanol Fuel	0.10
Income Tax Exemptions for Export Earnings	1982	Prestressed Concrete Steel Wire Strand	0.52
		Carbon Steel Welded Pipe	0.055
	1983	Certain Stainless Steel Products	1.93

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
		Frozen Concentrated Orange Juice	1.13
		Certain Steel Tools	0.84
		Certain Castor Oil Products	0.02
	1984	Oil Country Tubular Goods	1.06 1.27
	1985	Non-rubber Footwear	1.77
		Pig Iron	1.22
		Cast Iron Pipe Fittings	0.48
		Agricultural Tillage Tools	0.07
		Iron Ore Pellets	0.65
		Ethanol Fuel	0.44
		Iron Construction Castings	1.26
IPI-Federal Export	1982	Prestressed Concrete Steel Wire Strand	12.5
		Carbon Steel Welded Pipe	8.35
		Carbon Steel Plate	5.40
	1983	Certain Castor Oil Products	2.13
		Certain Stainless Steel Products	10.65

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
		Certain Steel Tools	10.05
	1984	Certain Carbon Steel Products	7.50 10.78 8.71
	1985	Non-rubber Footwear	1.46
		Pig Iron	13.01
		Cast Iron Pipe Fittings	10.53
		Program Terminated	6.70
IPI Rebates for Capital Investment	1982	Prestressed Concrete Wire Strand	1.83
		Carbon Steel Plate	1.47
	1983	Certain Stainless Steel Products	0.80
		Certain Steel Tools	0.84
	1984	Certain Carbon Steel Products	3.21
		Oil Country Tubular Goods	6.91
Long-Term Loans	1982	Carbon Steel Welded Pipe	1.16
	1983	Certain Stainless Steel Products	1.38
		Certain Steel Tools	4.48

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Mineral Tax Incentives	1985	Iron Ore Pellets	4.50
PROALCOOL Industrial Credit	1985	Ethanol Fuel	0.30
Resolution 643--Incentives for Trading Companies	1985	Non-rubber Footwear	0.04
		Pig Iron	0.24
Resolution 674--Working Capital Financing for Exports	1982	Prestressed Concrete Steel Wire Strand	1.06
		Carbon Steel Welded Pipe	2.89
		Carbon Steel Plate	1.71
		Certain Scissors and Shears	2.03
	1983	Certain Stainless Steel Products	0.47
		Frozen Concentrated Orange Juice	1.64
		Certain Steel Tools	2.37
		Certain Castor Oil Products	1.58
	1984	Certain Carbon Steel Products	4.61 22.36
		Oil Country Tubular Goods	1.08 13.08 6.19 4.56

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
	1985	Non-rubber Footwear	1.46
		Pig Iron	3.17
		Cast Iron Pipe Fittings	3.20
		Agricultural Tillage Tools	3.30
		Iron Construction Castings	3.30
Resolution 68--Export Financing (FINEX)	1985	Agricultural Tillage Tools	2.91

Source: In addition to the general sources cited earlier, the main sources used in the preparation of this table are the United States International Trade Monitoring System and the testimony and finding on CVD cases in the Federal Register.

NOTES

1. United States International Trade Commission, Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan, USITC Publication 1632 (Washington, D.C.: USITC, January 1985), p. 54; and Federal Register, Volume 48, No. 42, 2 March 1983, p. 8839.

2. Federal Register, Volume 50, No. 43, 5 March 1985, p. 8756.

3. United States International Trade Commission, Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan, USITC Publication 1632 (Washington, D.C.: USITC, January 1985), p. 54

4. Federal Register, Vol. 47, No. 197, 12 October 1982, p. 44816.

5. United States International Trade Commission, Foreign Industrial Targeting and Its Effect on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan, USITC Publication 1632 (Washington, D.C.: USITC, January 1985), p. 55; and Federal Register, Volume 49, No. 29, 10 February 1984, p. 5163.

6. Federal Register, Volume 50, No. 173, 6 September 1985, p. 36460; and Estudios e Informes de la CEPAL, Trade Relations Between Brazil and the United States (Santiago, Chile: United Nations, 19850, pp. 55-57.

7. Federal Register, Volume 48, No. 109, 6 June 1983, p. 25252.

8. Federal Register, Volume 50, No. 155, 12 August 1985, p. 32464.

9. Federal Register, Volume 47, No. 154, 10 August 1982, p. 34611; and Ibid, Volume 50, No. 155, 12 August 1985, p. 32464.

10. United States International Trade Commission, Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan, USITC Publication 1632 (Washington, D.C.: USITC, January 1985), p. 45; Federal Register. Volume 50, No. 56, 22 March 1985, p. 11529; and Estudios e Informes de la CEPAL. Trade Relations Between Brazil and the United States (Santiago, Chile: United Nations, 1985), p. 58.

11. Federal Register, Volume 48, No. 94, 13 May 1983, p. 21614.

12. Federal Register. Volume 50, No. 43, 5 March 1985, p. 8757; and United States International Trade Commission. Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan, USITC Publication 1632 (Washington, D.C.: USITC, January 1985), p. 47.

13. *Federal Register*. Volume 46, No. 109, 6 June 1983, p. 25247; and Estudios e Informes de la CEPAL. *Trade Relations Between Brazil and the United States* (Santiago, Chile: United Nations, 1985), p. 54.

14. *Federal Register*, Volume 50, No. 35, 21 February 1985, p. 7208.

15. *Federal Register*, Volume 49, No. 82. 20 April 1984, p. 17993.

16. United States International Trade Commission, *Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan*, USITC Publication 1632 (Washington, D.C.: USITC, January 1985), p. 53 and 84; and *Federal Register*, Volume 49, No. 82, 26 April 1984, pp. 179989-18000.

INDIA'S EXPORT AND DOMESTIC INCENTIVE PROGRAMS

ANNEX D

I. EXPORT INCENTIVES

A. Financial Instruments

1. The Packing Credit Programs[1]

The Reserve Bank of India, through commercial banks, provides pre-shipment credit to exporters for financing the purchase, processing, or packing of goods. The objective of the program is to enable exporters to compete in international markets.

These credits may be received upon presentation of: (1) Letters of credit opened by an importer of goods outside India; (2) A confirmed and irrevocable order for export of goods from India; or (3) Any other evidence of an order for an export from India having been placed with the exporter. In general, the loans are granted for a period of 90 to 290 days and the rates are on the average approximately seven points below the commercial rate.

Since packing credit financing is only available for use by exporters and the rates of interest charged are less than the commercial rate, the ITA has determined that the provision of such financing provides a countervailable benefit.

2. Preferential Export Financing

The Industrial Bank of India (IDBI) was established in 1976 to assist in the modernization and rehabilitation of five selected industries; engineering and textiles were the two largest recipients of loans. The program was also intended to help importers meet their export objectives.

Loans were provided at low interest rates that tended to be 2 to 3 points below commercial rates. IDBI also participated as a guarantor on behalf of the exporters.

The International Trade Administration (ITA) maintains that these loans confer a grant because they target a selective group and offer preferential interest rates.

3. Post-Shipment Export Financing

The Reserve Bank of India provides post-shipments financing for a specific group of manufacturers, and therefore the ITA argues that this program is countervailable.

B. Fiscal Instruments

1. Cash Compensatory Support Program (CCS)[2]

The CCS is India's most prevalent export incentive program. It was introduced in August 1966 and was designed to facilitate exports through the compensation of various indirect taxes paid in the production of export goods, and not reimbursed under other programs. Intermittently, the program has supported exports of specifically non-traditional products to overcome high domestic short-run marginal costs of production. The subsidy consists of cash assistance equivalent to a certain percentage of the f.o.b. value of exports. This rate could vary from as low as 0.5 to as high as 18.6.

Engineering and chemical goods accounted for approximately 50 percent of total cash assistance expenditures between 1970 and 1980. Woolen carpets, rugs, processed food, finished leather and leather manufactures, natural silk fabrics and garments comprised the other 50 percent of assistance.

In the past, critics have denounced the government for its narrow concentration in a few product categories; delays in cash disbursements; and quarterly announcements of cash assistance which make it difficult for firms to plan investment in export activities. Furthermore, many analysts argue that this program concentrated on industries with the least comparative advantage.

The aim of the program is consistent with U.S. trade laws, but in some cases, its application has resulted in countervailing action. In these cases, the Indian exporters were unable to document the relationship between the indirect taxes paid and the cash payments under CCS.

2. Import and Excise Tax Duty Refunds

The primary objective of the program is to repay exporters for excise and import duties paid on inputs used primarily in export production. Duty refunds comprise the largest export subsidy after cash assistance. Import duties are 45 percent on capital goods and between 50 and 300 percent on raw materials. The import duty is refunded when the finished good is exported.

The refund is usually computed at a specific rupee value, not on an ad valorem percentage rate, and is computed quarterly to reflect changes in import prices.

During the 1970s, manufacturers of machinery and transport equipment received high rates of duty refunds. Interestingly enough, chemicals (a major recipient of cash assistance and import replenishment licenses) received only 4 percent in the form of duty refunds of total export incentives. Iron and steel products, engineering goods and textiles manufactures accounted for over 65 percent of the total value of duty refunds given during the 1970s.

The major problems associated with this scheme are: 1) its availability to only selective groups of industries/products; 2) duty refunds do not allow for wastage, which raises the costs of production; and 3) delays in refunding the duties.

The ITA determined that the refund of import and excise tax duties confers a subsidy if it benefits a select group of industries.

3. Income Tax Deduction for Overseas Expenses

Prior to 1978, exporters could deduct 150 percent of their overseas business expenses from their taxable income. Between 1978 and 1983, the rate was reduced to 133 percent of overseas business expenses and on March 1, 1983 the program was eliminated.

4. Export Markets Development Allowances

The government of India provides a special tax deduction for capital investment in new equipment and newly established undertakings.

This subsidy is available to all industries and is therefore not considered to be countervailable under U.S. law.

C. Other Instruments

1. Import Replenishment Licenses

The Government of India instituted an import-replenishment scheme in August 1966. Under this program, exporters are assigned import licenses of a value equivalent to a pre-specified percentage of f.o.b. amount of exports. The purpose of the scheme is to enable exporters to replenish their stocks of imported inputs. This program does not involve a direct budgetary outlay, instead it entails cross subsidization by manufacturers requiring imported raw materials to exporters granted import licenses in excess of their own requirements. The linkage between export performance and availability of import licenses is very high. Exporting firms that do not fulfill their export commitment may be actually penalized through stricter import licensing. Where as firms exceeding export goals receive liberal import licensing treatment.

Although the program appears to be strictly intended for the purpose of replenishing stocks of imported materials necessary for the production of exports, import licenses are negotiable and, since they carry a scarcity premium, can result in a benefit to the exporters. The degree of tranferability of import licenses has steadily increased to a point where import replenishment license premiums* constitute the third largest export subsidy after cash assistance and duty drawbacks.

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*The benefits accrued from the sale (transfer) of the import replenishment license.

In April 1979, the Indian government substantially overhauled the import restriction policies and reduced the number of goods requiring an import permit by over 90 percent. Since 1979, Mr. Rajiv Ganhdi has reduced the number of restricted imported goods even further.

Recently, import replenishment licenses have been used to upgrade the technology of export-oriented firms. Export firms may import technical designs and new machines against their own replenishment licenses.

There are two significant disadvantages. First, the program is selective and concentrated on only a few goods. Second, the value of import licenses fluctuate directly with the business cycle and with the foreign exchange scarcity.

The U.S. Department of Commerce argues that utilization of import licenses, for other than stock replenishment, is considered a subsidy.

2. Market Development Assistance Program[3]

Under the Market Development Assistance program, grants are provided for export promotion to the Engineering Export Production Council (EEPC) and the Trade Development Authority (TDA). These grants are used to operate overseas offices and organize exhibits designed to promote Indian exports. Firms under these organizations pay dues which exceed any specific benefits they derive from EEPC and TDA activities. In addition, the firms are billed for all special services, such as participation in trade shows and listing in directories.

The ITA decided that the market development assistance program does not amount to a subsidy under U.S. countervailing law.

3. Free Trade Zones (FTZ)[4]

There are two free trade zones in India: Kandla and Santa Cruz. Benefits granted to companies located in these regions include: special foreign exchange concessions; duty-free import privileges; financial assistance for purchase of equipment; and a ten-year income tax holiday on 20 percent of the profits made in the zone.

4. Export Credit Insurance

The Government of India charters the Export Credit Guarantee Corporation (ECGC) to insure export transactions against default. It is a commercial entity that charges sufficient rates to cover its operating expenses and make a profit. Accordingly, the ITA determined that ECGC insurance does not amount to a subsidy.

5. Green Cards

In January 1981, the Indian Government launched a scheme that enabled export-oriented manufacturers, in possession of a "green card," to obtain and receive priority treatment in importing capital goods, raw materials and components for key investments. These industries also received preferential treatment regarding customs clearance, preferential credit rates, and priority access to transportation and facilities.

The ITA determined that this program was counteravailable.

6. Supply of Indigenous Materials at International Prices

Prior to 1966, the Indian government subsidized the engineering industry through the provision of iron, steel, and tinplate at below domestic market prices. In May 1967, the scheme was extended to aluminum, PVC resin, and winding wires. Because the incentive was restricted to certain activities, the ITA determined that this program was countervailable.

7. Freight Rate Subsidy

Until 1980, railway and shipping subsidies were available to exporters of certain goods. The engineering sector was entitled to rail freight concessions up to 50 percent if the product had to be transported by rail more than 200 miles. While it was in existence, it was considered to be countervailable under U.S. law.

II. DOMESTIC INCENTIVES

A. Fiscal Instruments

1. Tax Deductions for Capital Equipment and New Industrial Undertakings[5]

The Government of India allows income tax deductions for purchases of new capital equipment and establishment of new industrial enterprises.

The ITA found that these deductions were available to a broad range of producers and therefore they do not constitute subsidies within the meaning of U.S. countervailing laws.

B. Other Instruments

1. Regional Benefits to New Facilities in Madhya Pradesh

The Government of India provides certain regional development incentives in the state of Madhya Pradesh. They include:

a) Preferential power rates;

b) Investment grants;

c) Sales tax exemptions on deferrals;

d) Feasibility study cost reimbursements; and

e) Preferential water rates.

The ITA made no formal decision regarding this program because the alleged user was found not to be located in the Madhya Pradesh regions.

2. Raw Materials Subsidies

The Government of India sets prices for many raw materials. Thus domestic users can purchase raw materials at concessional rates.

3. Grain Subsidies

The Indian government first introduced grain subsidies in 1951. The primary objectives of the grain subsidies were to maintain a buffer stock in the event of a bad harvest and assist in the distribution cost. Throughout the 1970s and early 1980s food subsidies grew more than 12 times.

4. Fertilizer Subsidies

The subsidy on fertilizers has grown to be the second most important subsidy in magnitude next to food subsidies. It is intended to induce greater uses of fertilizers and promote income re-distribution in favor of the farmers. It applies to domestically produced nitrogenous fertilizers, indigenously produced phosphatic fertilizers, imported fertilizers, and the freight on fertilizers. The retail price of fertilizers is maintained at a uniform rate throughout the country.

5. Subsidies to the Khadi and Village Industries Commission (KVIC)

The purpose of this domestic incentive is to promote labor intensive industries and regional development. The KVIC borrows from the government at 7.5 percent interest rates and then lends the capital at zero interest rates to the Khadi industry and 4 percent to village industry. The footwear industry was a major recipient of financial assistance.

6. Interest Subsidies to Various Public Sector Activities

Interest subsidies are also provided by the government to various public sector activities. The largest beneficiaries have been the Shipping Development Fund Committee, the Steel Authority, the Indian Iron and Steel Company, the National Mineral Development Corporation, Heavy Engineering Corporation, and Indian Drugs and Pharmaceuticals Limited.

Most public sector corporations are subject to tight administrative price controls and product prices of their products are less than the cost of production. This has led to inefficiencies and heavy operation losses. To cover cash losses, the government pays subsidies to these corporations to help them meet interest payments and other costs.

Analysts argue that the selectivity and inefficiencies of the pricing system are the two major drawbacks of this type of subsidy which has created major price resource allocation distortions.

7. Consumption Subsidies

The government provides certain transportation, housing and regional development incentives to aid the poor and promote regional growth. Subsidies are also given to victims of cyclones, floods, drought, and other natural disasters.

INDIA'S COUNTERVAILABLE SUBSIDY PROGRAMS UNDER U.S. LAW

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Cash Compensatory Support Program (CCS)	1980	Industrial Fasteners	17.5
	1983	Footwear	15.0 12.5
	1984	Oleoresins	N.A.
		Certain Iron Metal Castings	1.68
Export Markets Development Allowance--Income Tax Deductions	1980	Industrial Fasteners	0.1
		Certain Iron Metal Castings	3.6 2.0 0.9 0.2 0.4
Import Permits	1978	Certain Textiles and Textile Products	0.001
Income Tax Deductions for Overseas Business Expenses	1983	Footwear	0.03 0.05

INDIA'S COUNTERVAILABLE SUBSIDY PROGRAMS UNDER U.S. LAW

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Packing Credit Programs	1980	Certain Iron-Metal Castings	0.4
	1985	Certain Carbon Steel Pipe and Tubes	0.42
Preferential Export Financing	1984	Industrial Fasteners	0.4
	1978	Certain Textiles and Textile Products	0.19
Pre-shipment Export Loans Program	1984	Certain Iron-Metal Castings	7.4
Short-Term Preferential Financing	1983	Footwear	0.03 0.05

Source: This table was comprised of information obtained from the U.S. Department of Commerce's Subsidies Library and the Federal Register.

NOTES

1. *Federal Register*. Volume 50, No. 251, 31 December 1985, p. 53368.
2. *Federal Register*. 20 July 1980, p. 48607; and Ibid., Vol. 50, No. 251, 31 December 1985, p. 53368.
3. *Federal Register*. 16 October 1980, p. 68650.
4. *Federal Register*. Vol. 50, No. 251, 31 December 1985, p. 53368.
5. *Federal Register*. 20 August 1980, p. 55502.

INDONESIA'S EXPORT AND DOMESTIC INCENTIVE PROGRAMS

ANNEX E

I. EXPORT INCENTIVES

A. Financial Instruments

1. The Investment Coordinating Board (BKPM)[1]

Since 1977, BKPM has been the central investment authority in Indonesia. All approvals, licenses and permits required to establish or expand production facilities in the country must be obtained from BKPM. BKPM approval is also necessary for fiscal grants and other incentives such as the holidays and accelerated depreciation. Because of its crucial role in directing inward and domestic investment, BKPM has largely influenced the development of Indonesia's export sector.

In addition to the responsibilities listed below, BKPM has twelve major obligations:

- coordination and planning in sectoral and regional investments and the synchronizing of these plans with a master plan;
- formulation of investment policies;
- preparation and publication of priority lists;
- encouraging the spread of investment activities to the provinces in accordance with development policies;
- supervising the implementation of approved investments;
- development and processing of priority projects;
- encouraging and fostering the completion of investment projects;
- establishing effective promotional communication with investors in particular and the business world in general;
- evaluation and screening of investment applications;
- approval of domestic investment applications; and
- provision of general investment services.

A. Financial Instruments

1. Preferential Short-term Financing for Non-Oil Exports - Decree No. 16/9/KEP/DIR/83 of June 1, 1983.

The primary objective of this program is to provide working capital export credits at preferential interest rates to Indonesian exporters. This program, administered by Bank Indonesia, receives funding from Indonesian state banks and private national foreign exchange banks.

Eligibility for short-term financing is contingent upon export performance and type of commodity.

The interest rate for export credits is fixed at nine percent. After the exporter has submitted documents certifying that the export has been carried out, the commercial bank refunds the difference between the interest paid and nine percent.

When the ITA investigated this program they found it to be countervailable, because interest rates were below the commercial rates. When Indonesia signed the GATT subsidy code in March 1985, it agreed to phase out preferential export credits over a year period.

B. Fiscal Instruments

1. Import Duty Exemptions for Capital Equipment

Under the Corporation Tax Ordinance of 1925 (CTO), firms complying with national long-term objectives are exempted from payment of duties on imported raw materials and imported capital equipment.

The ITA states that this program confers a bounty, because the exemption is contingent upon export performance.

2. Export Certificate Scheme

The Export Certificate Scheme was established in November 1978 and has been amended several times since its inception. This scheme, administered by the Department of Finance, Trade, and Industry, and by the Customs and Excise Inspectorate, is designed to simplify rebate of import duties and indirect taxes borne by exported products.

The program was determined not to be countervailable, because the rebate is officially prohibited from being greater than the total of duties plus indirect taxes paid for imported materials physically incorporated in the product.

3. Value-Added Tax (VAT)

Under the new VAT system, exports are subject to VAT rate of zero percent. The tax paid is fully refundable to the exporting company.

C. Other Instruments

1. Free Trade Zones -- P.T. BWI

P.T. BWI is a private commercial venture established under Government Regulation # 20 of 1972 concerning Bonded Warehouses. P.T. BWI manages a free trade zone in Jakarta known as the Jakarta Export Processing Zone (JEPZ). P.T. BWI provides investors electricity, water, gas, and communications to investers on a commercial basis. Size is the only constraint on investors wishing to locate in the zone. Firms based in the zone are exempt from paying import duties without government approval. Outside the zone, government approval is necessary for exemption from import duties.

The U.S. Department of Commerce determined that this program was not countervailable.

2. Export Countertrade (Counterpurchase) Program (Keppres)[2]

This program, administered by the Indonesian Ministry of Trade, and implemented in January 1982, obligates foreign exporters to purchase an equivalent amount of specified Indonesian export commodities for contracts in excess of Rp. 500 million. Indonesian non-oil commodities that may be used to meet the counterpurchase requirement include rubber, coffee, paper, tin, tobacco, dried cassava, cement, sawn timber, plywood, other processed wood products, and certain textile products. Over U.S. $1.4 billion of counterpurchase contracts to cover a wide range of projects were signed between January 1982 and January 1986, of which $843 million have actually been exported, mainly to Japan, West Germany, and in the U.S.

This program was found by the ITA to be countervailable, in part because the Indonesian government failed to provide a complete list of transactions made under the program.

BIDA provides information related to prices, productive capacity, types of commodities, and quality of goods for interested exporters and importers. The association also provides information on services such as marketing, countertrade, packaging, and transportation.

3. Export Insurance

In 1985, the Government of Indonesia introduced insurance on exports and export credit, which is available at preferential rates through P.O. Askrindo, a state-owned insurance company.

4. Bonded Warehouse Systems[3]

The government established the bonded warehouse system to facilitate economic development, to ensure a smooth flow of imports and exports, and to increase international trade. This system is based on Government Regulation No. 20 (1972) and amended by Government Regulation No. 31 (1977).

The bonded warehouse system combines the characteristics of a free trade zone and an industrial estate. For example:

- It is a customs restricted area with customs privileged facilities;
- It has special regulations and procedures affecting import and export, flow of goods, foreign exchange, and investments; and
- It is a zone for bonded storage and bonded processing activities.

The facilities available in the bonded warehouse areas include covered storage for general, bulk, and container cargos, including storage facilities for dangerous cargo, and equipment to support cargo handling and warehousing activities.

An export processing zone is also available and provisions have been made for factories to be sited under this zone. Types of factories eligible for location in the export processing zone are those in light manufacturing which are export-oriented and labor intensive industries.

Investors intending to establish manufacturing or assembly facilities within the zone must obtain approval from the Investment Coordinating Board (BKPM) through the bonded warehouse administration. Those wishing to import or export from the zone must obtain permission from the Ministry of Trade.

Importers using bonded warehouse facilities need not make an advance deposit for purchase of foreign exchange to open a letter of credit until they wish to take delivery, thus avoiding the higher financial costs involved in direct delivery from distant suppliers.

Goods can be shipped to the site on consignment, to be released upon instruction of the supplier. No letter of credit is required and no import duties need be paid. The goods remain the property of the supplier and can be shipped back to any destination outside Indonesia, as long as they have not physically entered Indonesian customs territory.

The ITA has no formal position regarding this incentive, as it was not used by any of the companies under investigation.

5. "May 6 Policy Package"

Under the "May 6 Policy Package," the Indonesian government affirmed that exporters and contractors undertaking projects funded by the government are entitled to local raw materials sold at a price no higher than the world market. If the prices of domestic raw materials needed for certain activities exceeds the world market price, exporters and contractors are allowed to import the materials exempt from trade regulations.

II DOMESTIC INCENTIVES

A. Financial Instruments

1. Development Bank of Indonesia (Bank Pembangunan Indonesia - BAPINDO)

Established in 1952, BAPINDO, is the largest development bank in Indonesia and is primarily engaged in medium- and long-term financing. Although most of the credits are for five years, BAPINDO has been authorized to grant loans for 15 years. All industries are eligible for such loans, but priority is given to those considered instrumental in implementation of the five-year plans. BAPINDO allegedly sets interest rates based on commercial considerations. It also administers "second window" loans from funds of: (1) the World Bank; (2) the Asian Development Bank; (3) the Islami-Development Bank; (4) other international financial institutions. Interest on these loans is based on a "spread" above the interest rate on funds.

B. Fiscal Instruments

1. Corporation Tax Ordinance of 1925 (CTO)

Under this scheme, the Indonesian Ministry of Finance grants tax benefits to specific investments in "priority" industries (as defined by the Badan Koordinasi Penanaman Model (BKPM) or Investment Coordinating Board). These tax benefits include:

a) A two-year corporate tax holiday;

b) Accelerated depreciation on capital investment for four years after the expiration of the holiday period;

c) Exemptions from the capital stamp duty and dock clearance tax; and

d) A tax reduction of up to 20 percent of yearly capital investment.

The priority investment lists are called Daftar Skala Priorities (DSP) and govern both domestic and some foreign investment in Indonesia. Industries listed on the DSP are intended to help meet the government's long-term economic objectives, which include the creation of jobs, regional development, equitable distribution of the returns to development, and the accumulation of foreign exchange. DSP status is also dependent upon the industry; whether the investment is new or for expansion; whether the investment is located outside Java; and the level of priority designated by the Indonesian government.

The ITA argues that the benefits offered under this program are not available to all industries and therefore confer a bounty or grant.

2. Government Regulation # 2/1981 (GR-2)

Under this regulation, the Ministry of Finance provided tax relief to companies earning "substantial" foreign exchange from exports. Relief was alleged to include:

a) Exemption of up to 100 percent of corporate tax on export earnings for a period of up to ten years; and

b) 50 percent reduction of corporate dividends tax on export activity for up to ten years.

In December 1983, GR-22 became moot under the net tax legislation.

3. Tax Reductions Under Decree # KEP-1677/MK and Decree # 112/KMK

Prior to 31 March 1984, the government provided a variety of benefits to stock companies, with the goal of creating an active stock market and promoting the growth of private firms. In particular, there are two decrees worth mentioning, Decree #KEP-1677/MK and Decree #112/KMK.

Decree KEP-1677/MK was available to a broad range of companies issuing at least fifteen percent of their shares to the public or the local stock exchange.

Decree 112 provided tax corporate tax reductions to companies listed on the Indonesian stock exchange that offered at least 20 percent of their shares to the public.

Since these two programs were not used by firms under U.S. investigation, the ITA made no official statement regarding these two programs.

C. Other Instruments

1. Industrial Estates

The Government of Indonesia places high priority on the industrial estates located throughout the country. They are perceived as being a key to increasing regional development and promoting the manufacture of export-oriented products.

Three industrial estates are currently in operation, with several others at various stages of planning and development. Chemicals and basic metals are the two most highly represented sectors operating in industrial estates.

Industrial estates offer the foreign investor an easy means of obtaining land and land rights, building permits, site formation, and other infrastructure facilities such as water, electricity, sewage systems, telephones and other support facilities.

By the end of the third Five-Year Development Plan, there were 10 industrial zones, and the government projects the establishment of 22 additional zones during the fourth Five-Year Development Plan.

INDONESIA'S COUNTERVAILABLE SUBSIDY PROGRAMS UNDER U.S. LAW
1985

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Corporation Tax Ordinance of 1925	1985	Certain Textile Manufacturers	0.08
Import Duty Exemptions for Capital Equipment	1985	Certain Textile Manufacturers	0.019
Preferential Short-Term Financing for Non-Oil Exports	1985	Certain Textile Manufacturers	0.83 0.565

Source: Federal Register, Volume 50, No. 74, 17 April 1985, pp. 15208-15213; Ibid, Volume 50, No. 48, 12 March 1985; Ibid, Volume 49, No. 200, 15 October 1984, pp. 40198-40200.

NOTES

1. Indonesia: A Guide for Investors 1984/85 (Jakarta, Indonesia: The Investment Coordinating Board, 1985), p. 67.

2. Foreign Economic Trends--Indonesia (Washington, D.C.: U.S. Department of Commerce, January 1986), p. 165.

3. Indonesia: A Guide for Investors, 1984/1985 (Jakarta, Indonesia: The Investment Coordinating Board, 1986), p. 51.

MEXICO'S EXPORT AND DOMESTIC INCENTIVE PROGRAMS

ANNEX F

I. EXPORT INCENTIVES

A. Financial Instruments

1. Fund for the Development of Exports of Manufactured Goods (Fondo para el Fomento de las Exportaciones de Productos Manufacturados) FOMEX

FOMEX, a trust established in 1963 by the Mexican government and administered by BANCOMEXT, promotes the manufacture and sale of manufactured exports through pre-export and export loans, at interest rates and with maturity dates comparable to those offered by international suppliers. While FOMEX also finances both export and import purchases related to pre-export activities and import substitution, export sales financing is the largest FOMEX program. FOMEX disbursed 165 billion pesos in export sales financing in 1983, compared with about 68 billion for import- substitution. In 1983, the percentage of total exports assisted by FOMEX sales finance was 21.1 percent; the comparable figure for manufactured exports was 25.4 percent. This was a significant decline from a level of assistance equal to 42 percent of manufactured exports in 1981.[1] It was the largest and most important export financing program.

Eligibility for FOMEX pre-export and export loans was based on several criteria: the percentage of Mexican capital invested in the company; the type of manufactured product; the percentage of national content in direct production costs; ownership of insurance covering the full scope of the loan; preparation of a SECOFIN*-registered export program; the destination of the exported good; and the length of the credit terms.

In January 1985, the minimum rate for short-term dollar credit (less than 2 years maturity) stood at 70 percent of the six month libor rate. Long-term export credit terms followed the schedule of the Arrangement on Export Credits of the Organization of Economic Cooperation and Development (OECD). In order that such credits not be considered an export subsidy, Mexico was mandated to adhere to official OECD guidelines for export credit interest rates. For pre-export and import-substitution financing, the minimum rate of interest was 50 percent of CPP** for credit issued after September 30, 1984. If a company's products had 50 percent or more local content, 100 percent of the cost of production and 70 percent of the invoice value of production-related imports could be financed. If the company's export program was registered with the Mexican Institute of Foreign Trade (IMCE), 85 percent of the cost of imports could be financed; and if local content was between 30 and 50 percent, pre-export financing would support 100 percent of Mexican content.[2]

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*SECOFIN is the Ministry of Commerce and Industry.

**CPP-interest rates on most peso denominated loans are based on the average rate of banking system for its funds, the Costo Procentual Promedio de Captacion de Mondea National.

The U.S. International Trade Administration determined that the receipt of pre-export and export financing through FOMEX was countervailable, as it constituted a bounty or grant through the provision of loans for export purposes at interest rates significantly less than the interest rates for commercially available loans. Effective 1 September 1983, the subsidy was reduced by one-third for maturities of two years or less, by 50 percent as of the end of 1985; it was totally eliminated at the end of 1986.

2. Article 94 Loans

The Banco de Mexico established 12 categories of industries eligible for financing under Section II of Article 94 of the General Law of Credit Institutions and Auxiliary Organizations. Category 12 provides preferential loans to exporters for financing production and/or inventory of manufactured goods intended for export.

Most categories carry their own maximum interest rate set by the Banco de Mexico. Category 12 consists only of exports of manufactured products, and carries a maximum interest rate of 8 percent, which has been far below the comparable commercial rate. Some of the remaining 11 categories bear maximum rates above 8 percent, but still below the comparable commercial rate. This incentive is available to a broad spectrum of industries. The U.S. Department of Commerce found Article 94 Loans among the countervailable subsidies in certain cases. Article 94 Loans were determined to grant a bounty amounting to .05 for carbon steel products and 1.70 ad valorem for red lead.

3. Mexican National Bank for Foreign Trade (BANCOMEXT)

BANCOMEXT is the official export-import bank of Mexico and the principal government financial institution for facilitating non-oil exports and improving Mexico's balance of payments situation. It is responsible for promoting import-substitution as well as expanding exports of manufactured goods through financial incentives for investment, production, and imports of raw materials.

To qualify, companies are expected to adhere to certain criteria. Companies must be found creditworthy by BANCOMEXT, present an annual export plan, and be located in Mexico. Importers are required to have import licenses, and imports must be used in priority activities defined by the government. Forms depend on the goods imported and vary from 30 days to one year for raw materials and up to eight and a half years for capital goods. In 1985, about 30 percent of total export financing was made at preferential rates and about 70 percent at commercial rates. Approximately 50 percent of import financing was granted at preferential rates.[3]

As of the end of June 1983, support for imports comprised 38 percent of all credits; by comparison, financing represented 31 percent of all lending.

The U.S. International Trade Commission (ITC) has determined that the bounties conferred by BANCOMEXT were countervailable. In the subsidy case involving lime producers, the ITC found that BANCOMEXT not only provided loans at interest rates lower than those for comparable commercially available loans, but also rolled over missed interest payments for one firm.

4. Program for the Financing of Foreign Exchange for Exports (Programa de Financiamiento de Divisas para Exportaciones) PROFIDE

PROFIDE, a program administered by BANCOMEXT and financed by the World Bank, helps arrange foreign exchange deals for imports of products used to produce exports. Credit is granted directly to the foreign supplier. Terms are for a maximum of one year at interest rates 3 percent above the six-month banker's acceptance rate in New York. Maximum credit is US$ 50 million, or 60 percent of the firm's total annual export plan.

B. Fiscal Instruments

1. Import Duty Rebate System

In 1971, the Mexican government introduced CEDIs (Certificado de Devolucion de Impuestos), nontransferable tax rebate certificates specifically designed to promote exports of manufactured products. It was considered to be one of Mexico's most controversial and prevalent export subsidies.

CEDI certificates were granted according to the share of local content and export performance of the product. The tax rebate was 10 percent of the sales value of the product when domestic content exceeded 60 percent. When domestic content was between 50 and 60 percent, the rebate was 5 percent. No CEDIs were issued when domestic content was below 50 percent. CEDIs were nontransferable and could be used to pay a wide range of federal tax liabilities, including payroll taxes, federal income taxes, and import duties over a period of 5 years from date of insurance. In 1982, the Mexican government suspended CEDIs, partly to increase revenue and partly in reaction to U.S. government imposition of countervailing duties on a number of Mexican imports benefiting from the certificates.[4]

Since 1982, CEDIs have been replaced by other import duty rebate schemes that are acceptable to the U.S. government, primarily because they attempt to avoid excessive remission or drawbacks of import charges. For example, exporters may receive a rebate on the duty paid on imported inputs used to produce exports within 10 days of paying the duty. According to ITC officials, this rebate does not constitute a resurrection of the previous CEDI program. Other import duty arrangements are available to exporters, depending on whether imports are used for in-bond assembly plants, compliance with the Foreign Investment Law, volume and value of exports, and location of firm.

For example, owners of in-bond assembly plants have intermittently been able to import duty-free, materials, components, and supplies not available in Mexico for the production of exports. Furthermore, in July 1986, the Mexican government lowered the bonds from 100 percent to 40 percent of the value of the imported good held in warehouses. This incentive has resulted in a substantial reduction in the funds of customers tied up in inventories. Also, a number of ports and regions are designated as free trade zones to which merchandise and equipment can be shipped free of customs duties and with a minimum of control, as long as they do not enter the rest of Mexico. The only control mechanisms placed on this group of importers is the requirement of import permits and adherence to exchange control regulations.

2. Tax Incentives for Transportation, Insurance, and Storage Expenses

Tax breaks that maximize deductibility of export-related expenses, such as warehousing and promotion costs, are also offered. Officials permit extensions up to 180 days for export storage time and do not require payment of applicable taxes on exports until actual date of shipment.

An industry may receive direct or indirect tax rebates or price discounts on freight, vessel, insurance, or terminal storage expenses incurred for domestic transportation of the product from plant to seaports or from the plant to border points for export to the U.S. A firm may also receive price discounts for brokerage fees, seaport handling, ocean freight, or ocean insurance. As none of the Mexican companies investigated by the ITC used this incentive, the ITC has not formally declared this incentive to be countervailable.

3. Export Credit Insurance

The Mexican Credit Insurance Company (COMESEC) provides commercial risk insurance at preferential rates for exporters. Its intended purpose is to cover sush risks as importer's failure to pay due to inconvertibility, arbitrary expropriation, unfounded refusal to pay on the part of the importer's bank, or default by an importing public institution or governmental agency. COMESEC is owned by private insurance companies with paid-in capital of P10 million and renders an operating profit on insurance activities. It offers insurance for both global exports and specific shipments, with a maximum coverage of 80 percent for the former and 70 percent for the latter. Premiums vary from 0.24 percent to 5 percent, depending on risks, they average about .6 percent.

FOMEX contracts export insurance for up to 90 percent of export value. Premiums vary according to contract terms and export destination.

The ITC has determined that the export insurance program does not confer bounties or grants, and is therefore not countervailable.

C. Other Instruments

1. Trust Fund for the Coverage of Exchange Risks (Fideicomiso para la Corbertura de Reisgos Cambiarios) FICORCA--Devaluation on Long-Term Debts

Banco de Mexico also sponsors a plan to reduce the risk of foreign exchange loss arising from future devaluations of the Mexican peso. The program is carried out by the Trust Fund, FICORCA, established by the Ministry of Planning and Budget.

Under this program, coverage is available to all Mexican companies, privately or publicly-owned, with long-term debts to Mexican banks, foreign financial institutions, or foreign suppliers that originated prior to December 20, 1982 and were registered with the Ministry of Finance or the Ministry of Commerce and Industrial Development. The terms of the indebtedness are renegotiated according to whether a company wants coverage only for principal payments or for both principal and interest payments.

The Mexican debtor pays the full amount of the indebtedness in Mexican pesos to FICORCA at the time of signing for the operation. FICORCA then pays US dollars to the creditor outside Mexico. The peso equivalent of the liability is calculated at rates somewhat lower than those in effect in the controlled market.

Future interest on the liability in foreign currency is payable by the debtor directly to the creditor, and the amounts needed are obtained by buying US dollars at the time of each payment. It is also possible for an exporter or importer to obtain coverage for both principal and future interest on the foreign currency debt.

The majority of the companies apply for a peso loan from FICORCA repayable in foreign currency in monthly installments of interest, and later of principal, over the period of the indebtedness.

Due to exceptionally favorable loan terms provided by FICORCA, both leasing and factoring companies have large cash reserves and are able to offer their clients favorable finance packages.

Mexico's leasing companies (arrendadoras) use part of the heavy liquidity to increase their traditional business and purchases of fixed assets ranging from machinery and computers to vehicles. The interest rate charged by arrendadoras on their leased capital is based on their FICORCA peso credit cost, which is the average 3 to 6 month peso deposit yield, plus a 6 to 7 point spread as well as 1 percent commission. The term is the normal life of the asset being financed.

Some leasing companies also make direct loans for working capital purposes or to finance expansions, although they are technically not allowed to do so. A 30 day working capital credit carries a 6 to 7 point spread over the FICORCA rate. Since leasing companies do not require a compensating balance, or deposit representing a share of the loan, the effective rate of these loans is several points below the cost of regular bank credits, which require a cash deposit of up to 20 to 25 percent against the loan.

Mexico's factoring enterprises have also benefited from generous FICORCA arrangements, as well as fresh capital injections by new shareholders (most factoring companies were formerly owned by Mexican banks and have been sold off to private investors since the nationalization). Because of this unusual liquidity, factoring costs are now actually below those of bank loans.

Factoring companies recently introduced a new service through which they finance the accounts receivable of suppliers to their major clients. The factoring firm pays the invoice when presented by the supplier, while the client has a 90-day term to cover the invoice. In January 1986, the cost for suppliers was CPP plus 7 to 8 points. The scheme is designed for smaller companies that would not have access to financing without the guarantee of their customer.

FICORCA was determined by the U.S. Department of Commerce not to be countervailable under U.S. law, because the program is available on an equal basis to all Mexican firms with foreign debts and is not tied to exports.[5]

2. Trade Services

Instituto Mexicano De Comercio Exterior (IMCE) provides a series of services that include marketing research and initiating special projects. IMCE organizes and directs trade fairs abroad, promotes the visits of foreign trade missions, identifies national products or services that might be in demand abroad, and provides exporters with technical assistance, training personnel, and marketing assistance.

The support offered under the IMCE program to exporters (in agriculture, fishing, mining, manufacturing, and horticulture) may consist of reimbursement of 50 to 75 percent of the costs of export-promotion. The support is provided for products with a high national content and those enterprises falling into either the small- or medium-sized category. (Small companies are defined as having shareholders equity of between PS 50,000 and PS 7 million. Medium-sized companies are those with shareholders equity of between PS 7 million and PS 60 million.)

The ITC argues that these types of services are "a proper and legitimate function of government, services that all governments provide." Therefore, they are not considered to confer a bounty or grant.

3. Trading Companies

Trading companies have been given an enlarged role and are eligible for open import licenses for raw materials and machinery for one year's worth of their members' import requirements. (In 1985, import licenses covered only half the previous year's imports of an individual firm.) Trading companies are also permitted to import, in proportion to their net foreign exchange earnings, finished goods for which import authorization would otherwise be withheld. Joint ventures between local and foreign trading companies are permitted, provided such affiliations result in increased exports.

II. DOMESTIC INCENTIVES

A. Financial Instruments

1. Fund for the Guarantee and Development of Small and Medium Industry (Fondo de Garantia y Fomento a la Industria Mediana y Pequena) FOGAIN

FOGAIN, a trust operated by NAFINSA, offers inventory and industrial equipment credits and is specifically designed to develop small- and medium-sized businesses. FOGAIN is one of the largest industrial funds, with total disbursed loans in fiscal year 1983 totaling over 52 million pesos. 99 million pesos were allocated for 1984.[6] In 1982 and 1983, 80 percent of the funding was targeted to the manufacturing industry; 23 percent to the textile and apparel firms; 18.9 percent to food processing companies and 18.3 percent to metal, mechanic, and electrical product manufacturers.

2. National Fund for Industrial Development (Fondo Nacional de Fomento Industrial) FOMIN[7]

FOMIN, a trust operated by NAFINSA, provides funds for industrial development through stock acquisition or the provision of convertible loans at rates below those of commercial lending institutions. A little over 1 billion pesos was channeled to industry through FOMIN in fiscal 1982/1983. In 1983, FOMIN's stock portfolio in 113 companies was worth 3.3 billion pesos. The sectoral distribution of lending under FOMIN consisted of 8.4 percent to iron and steel; 33.7 percent to food products; 11.1 percent to textiles and apparel; 6.5 percent to chemical products; 12.5 percent to metal and electrical products and machinery; and 10.1 percent to cement and building materials.

3. Fund for Industrial Development (Fondo de Equipiamiento Industrial) FONEI

FONEI is a specialized financial development trust fund administered by the Bank of Mexico. It grants long-term preferential credit for the establishment, expansion, or modernization of industrial enterprises. This is achieved by financing technological development programs, preinvestment studies, and acquisition of fixed assets. Of all credit authorized by FONEI in 1980, 14 percent was allocated to promote export production, 53 percent to promote import-substitution, and 33 percent for project involving both.[8]

In 1983, metal machinery and equipment absorbed more than 40 percent of credits granted. Chemicals and petrochemicals, textiles and products, and food also consumed large shares of FONEI resources.[9]

The U.S. Department of Commerce found in several countervailing cases concerning imports from Mexico that such imports benefited from selective financial assistance under FONEI.

4. Fideicomicos Instituidos En Relacion Con La Agricultura (FIRA)

FIRA, a series of trusts established in 1954 and administered by the Bank of Mexico, provides credit to private and public institutions for the production of basic foods, agroindustrial activities, and exportable products. The primary goal of FIRA is to develop and support Mexico's agricultural sector, particularly small agricultural producers. Only a small portion of FIRA credit is for exports.

FIRA consists of three different trusts:

1) The Guarantee and Development Fund for agriculture, livestock, and poultry (FONDO) which grants credit for working capital, i.e. the purchase of seeds, fertilizers, and other inputs;

2) The Trust for Agriculture and Finance (FEFA), which provides long-term investment credit to producers; and

3) The Trust for Technical Assistance and Guarantee for Agriculture Credit (FEGA), which guarantees credits granted to low income growers. FEGA also reimburses both private banks and the State Rural Credit Bank for technical services provided to growers.

The benefits can include short- and long-term financing for up to 2 years, medium- and long-term financing up to 15 years, and technical assistance for basic food production. The great bulk of the short-term credit goes to the northern and northwestern regions, but the long-term lending is more evenly distributed geographically and tends to be devoted to the financing of beef and dairy cattle operations. Borrowers who have taken advantage of technical assistance services have, almost without exception, achieved large increases in output and in net income. Most of these were large-scale farmers with operating units of 200 acres and upward.

In December 1983, FIRA granted 200 million pesos in credit:

49.9% - basic food products
35.9% - livestock
9.6% - agricultural industry, agromechanical products and fishing
8.6% - exports.

Most of the financing (67.3 percent) was short-term credit for working capital. The allocation of FIRA credit, according to the type of producer is as follows:

39.9% - low-income producers
29.9% - middle-income producers
24.0% - other kinds of producers
12.2% - companies with liquidation problems.

5. National Fund for Preinvestment Studies and Projects (Fondo Nacional de Estudios y Proyectos de Preinversion) FONEP

FONEP is a trust established in 1968 and administered by the Nacional Financiera, S.A. Loans are granted to finance economic feasibility, engineering, or management studies for companies already operating but planning to expand, reorganize, or relocate.

In fiscal year 1982/1983, FONEP financed a total of almost 638 million pesos in feasibility studies. The largest amount of financing, 396 million pesos, went to industry studies. Within this category, the steel and iron industry and the nonferrous metal industry received the greatest share of funds. About 175 million pesos were allocated to studies for services industries.[10]

The ITC determined that FONEP was not countervailable, as financing of such feasibility studies is available to all companies in Mexico.[11]

B. Fiscal Instruments

1. Accelerated Depreciation Allowance*

For economic development purposes, the income tax department may grant accelerated depreciation on the basis of priority geographical regions or industrial activities.

Under normal tax depreciation schedules, machinery and equipment are subject to straightline depreciation over a 10-year period. Under such a schedule, 10 percent of the cost of the asset would be tax deductible in each of the 10 years. Under an accelerated schedule, 20 percent of the cost of eligible assets is tax deductible in each of five years.

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*Note: Depreciable costs are defined as including not only the purchase price of the assets but also freight and handling charges, insurance, commissions, fees, customs duties, and taxes, except the value-added tax. In general, all types of fixed assets, except land, are depreciable for tax purposes, as long as they can be shown to have been acquired for business purposes.

However, under recent amendments to the 1983 income tax law, the accelerated depreciation rates were revised to help stimulate the economy and offset the high rate of inflation. In 1984, fixed assets could be depreciated at 75 percent of their value; in 1985, 50 percent. During this period, firms, regardless of their location or type of activity, could take advantage of these rates. However, any new fixed assets acquired in 1986 could be depreciated at 50 percent that year, if located in a priority zone; the figure was 25 percent if a firm did not produce a priority good or was not located in a priority zone. Commencing in 1987, accelerated depreciation will apply only to fixed assets in priority industrial activities at rates of 50 percent in priority zones and at 25 percent in nonpriority locations.[12]

The ITC determined that accelerated depreciation allowances for machinery and equipment confer a bounty or grant, because such allowances are limited to a specific group of industries or to companies located in specific regions.

2. Certificados de Promocion Fiscal, CEPROFIs

CEPROFIs are tax credits, introduced in 1979, used to promote National Development Plan goals. CEPROFI certificates are tax credits of fixed value that may be used for a five-year period to pay any type of federal tax. Initially, CEPROFIs were only available to industries classified under Category I and Category II for increasing employment, encouraging regional decentralization, and industrial development--particularly of small- and medium-sized firms. In 1981, CEPROFIs were also extended to nonpriority industries.

CEPROFIs are issued for plant expansion and equipment purchases. The rate varies from 10 to 20 percent of investment costs, depending on whether the project involves a new plant or an expansion. Credits to small businesses can be as high as 25 percent of investment costs. CEPROFIs are also available in the form of employment credits that can amount to 20 percent of the incremental labor cost and cover a period of two years.

To qualify for CEPROFIs, Mexican companies must fulfill certain requirements and be at least 51 percent Mexican-owned. Credits must be approved by the Tax Incentives Office of the Ministry of Commerce and Industries Development (SECOFIN). Applicants must register with SECOFIN under an approved development program. And companies are expected to comply with performance requirements related to increasing production, required domestic content levels, price undertakings, and share of production exported.

One major restriction of CEPROFI benefits is that a company cannot be receiving any other tax benefits on the same investment, such as Federal tax benefits, local taxation incentives, or reductions of import duties. The company can, however, continue to receive import duty reductions implemented under special economic circumstances, such as severe shortages of raw materials and parts.

Between 1979 and 1981, nonmetallic minerals comprised 40.3 percent of CEPROFIs issued for investments. Basic metals represented 21.0 percent and chemical products 11.0 percent of CEPROFI benefits.[13]

The U.S. Department of Commerce has found that certain imports from Mexico frequently benefited from industry-specific or region-specific CEPROFIs. In such cases, these benefits were determined to be countervailable. In other cases, the Commerce Department found that CEPROFIs had been awarded on equal terms with all other companies participating in a development program that served the macroeconomic objectives of Mexico. Such instances were considered not to confer a bounty or grant under the U.S. statute.

3. Government Housing

All agricultural, industrial, mining, or other enterprises are obligated to pay a certain percentage of their wage bills into a government fund. A portion of the fund is allocated to government housing and other social services. Since many of the above industries are located in rural areas, this incentive tends to promote the migration of workers to these regions, causing a shift in the demographic pattern in Mexico. At the same time, by raising the cost of doing business, this tax tends to discourage hirings.

4. Food Subsidies (Sam-Sistema Alimentario Mexicano)

The SAM program, established in April 1980, was an effort by the Mexican government to guarantee a minimum level of nutrition for the Mexican populace and to achieve self-sufficiency in basic food products, particularly in corn and beans by 1982, and wheat rice, sorghum, and oil seeds by 1984. Through a series of subsidies, it promoted production, processing, marketing, and consumption of these items.

Under the SAM program, Mexican producers or exporters received the following benefits:

1) an increase of 30 percent in the guaranteed price of corn, and an increase of 50 percent for beans;

2) a reduction of 14 to 3 percent in the interest charges on production credit for beans and corn;

3) a reduction of 75 percent in the prices of corn seed and bean seed, and 30% in the prices of fertilizers used on those crops;

4) a reduction of 3 percent in the crop insurance premium for these commodities;

5) the expropriation of 3.4 million acres of ranch grasslands for transfer to ejidatorios to sow corn and beans;

6) duty reduction on imports of raw materials for the production and distribution of goods covered by the SAM program; and

7) tax credits for investments in vehicles used to distribute basic goods.

In January 1983, SAM was terminated. Under SAM, support prices were raised on crops for domestic consumption, which caused a shift from the production and cultivation of higher-value export crops to lower-value domestic ones. SAM, coupled with the appreciation of the real exchange rate, discouraged agricultural exports.

Today, the Mexican government is concerned with a shortage of corn. For years, corn prices were held down by the government to subsidize tortilla eaters in the city. Low prices, which were lower in real terms in 1985 than in 1925, and expensive production costs have discouraged domestic growers from producing corn. In 1985, Mexico's food import bill was 1.5 billion. In October 1986, the Mexican government finally removed the subsidy on tortillas, a socially and politically unpopular move, but nonetheless a crucial one.

C. Other Instruments

1. Preferential Prices for Natural Gas, Oil, and Electric Power

One of the most controversial industrial incentives is the provision of natural gas, oil, and electric power at preferential prices by Petroleos Mexicano (PEMEX), the special government entity that owns and controls production of petroleum products and natural gas.

The Mexican government, through PEMEX, maintains a two-tier price structure for petroleum and natural gas. The alleged first-tier benefit, granted under the National Industrial Development Plan (NIDP), results from the difference between the government-controlled domestic prices of petroleum products and natural gas paid by local manufacturers and the higher "world market prices." The second-tier benefit consists of a preferential 30 percent discount on the cost of industrial energy or basic petrochemical products. This price discount is given by the Mexican government to qualifying enterprises that are located in certain priority development regions (such as border areas) established under the NIDP.

The criteria for price differentials under the NIDP are contained in the regulations regarding price differentials. Under certain conditions, Articles 8 and 9 of the regulations allow 30 percent discounts on the cost of industrial energy or basic petrochemical products for firms located in Priority Zone IA. Article 9A exempts companies established in priority zones from the electric energy contractual fee. Article 9C allows companies located in Priority Zone IB that develop new industrial plants to receive a 30 percent discount on two of the following inputs: electric power, natural gas, combustibles, or basic petrochemical products. The cement industry as well as concrete block, lime, carbon black, ceramic tile, and ammonia receive an oil price benefit from PEMEX. At one time, PEMEX sold heavy fuel to domestic cement and other manufacturers for the equivalent of approximately $5 a barrel. The same oil was sold for export at $25-$30 per barrel.

2. Industrial Parks--Trust Fund for the Study and Growth of Commercial Centers, Industrial Parks and Cities (Fideicomiso para el estudio y fomento de conjuntos, parque, y cuid ades industriales)

FIDEIN has become one of the main instruments of the Mexican government's regional decentralization strategy. It promotes the development of industrial parks and cities, offering land to manufacturers at preferential prices on an installment basis. The trust also finances the renting of machinery on either a net lease or a lease-with-a-purchase option basis, for investors locating in an industrial park. FIDEIN financed 768.6 million pesos in sales of land in industrial parks and 189.1 million pesos in physical installation finance during the fiscal year 1982/1983.

3. Irrigation Facilities and Water Consumption

The lack of clean water and scarcity of fertile soil have resulted in the selective allocation of water supply and land for the specific use of various high-priority crops. The rate charged for water differs, depending on whether it is used for industrial, agricultural, or residential consumption. The water rate for all agricultural purposes is approximately 50 percent less than the rate for industrial and residential purposes.

MEXICAN COUNTERVAILABLE SUBSIDY PROGRAMS UNDER U.S. LAW
1982-1986

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Article 94 Loans	1984	Litharge, Red Lead,	1.70
		Certain Carbon Steel Products	0.05
Accelerated Depreciation Allowance	1983	Portland Hydraulic Cement	0.22
	1984	Certain Carbon Steel Products	0.001
BANCOMEXT	1984	Lime	de minimus
CEDIs	1982	Ceramic Tile	10% of FOB
	1983	Leather Wearing Apparel	10% of FOB
CEPROFIs	1982	Ceramic Tile	0.09
		Litharge, Red Lead	0.012
	1983	Polypropylene Film	4.91
		Pectin	0.68
		Portland Hydraulic Cement	5.21
	1984	Unprocessed Float Glass	1.02
		Bricks	0.35

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
		Certain Carbon Steel Products	2.30
		Reinforcing Bar and Merchant Bar	0.51
		Lime	1.37
		Oil Country Tubular Goods	4.25
	1985	Certain Textiles & Textile Products	0.0005
		Fabricated Automotive Glass	1.10
		Certain Welded Carbon Steel Pipes and Tubes	14.33
Discounts or Rebates for Natural Gas, Electricity or Oil	1983	Carbon Black	1.31
	1984	Oil Country Tubular Goods	0.24
FOGAIN	1983	Certain Iron Metal Construction Castings	0.13
		Pork Rind Pellets	0.218
	1984	Ceramic Tile	0.17
		Bricks	0.47
		Lime	0.70

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
	1985	Leather Wearing Apparel	0.54
		Certain Textiles & Textile Products	0.005
FOMEX	1982	Ceramic Tile	5.75
		Toy Ballons	5.97
		Playballs	6.23
		Litharge, Red Lead	3.377
	1983	Leather Wearing Apparel	3.35
		Polypropylene Film	0.77
		Pectin	10.51
		Yarns of Polypropylene Fibers	4.28
		Certain Iron Metal Construction Castings	0.12 2.49
		Carbon Black	N.A.
		Portland Hydraulic Cement	0.25
	1984	Ceramic Tile	1.62
		Toy Ballons	3.60

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
		Playballs	9.29
		Litharge, Red Lead	4.25
		Unprocessed Float Glass	1.52
		Bricks	1.85
		Reinforcing Bar & Merchant Bar	1.48
		Lime	0.36
		Oil Country Tubular Goods	1.35
	1985	Certain Textiles & Textile Products	3.7
		Fabricated Automotive Glass	3.58
		Certain Welded Carbon Steel Pipes and Tubes	1.61
FONEI	1983	Certain Iron Metal Construction Castings	0.17
		Carbon Black	0.04
		Portland Hydraulic Cement	0.01
	1984	Bricks	0.18

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
		Certain Carbon Steel Products	0.02
		Reinforcing Bar & Merchant Bar	0.04
		Lime	1.25
	1985	Certain Textiles & Textile Products	0.009
Import Duty Reductions or Exemptions for Equipment	1984	Lime	0.07
	1985	Certain Welded Carbon Steel Pipes and Tubes	0.21
Preferential State Tax Incentives	1983	Certain Iron Metal Construction Castings	0.0003
NAFINSA	1984	Lime	40.49

Source: In addition to the sources cited earlier, the main sources used in the preparation of this section are the United States Trade Representatives Monitoring System and the testimony and findings on CVD cases in the *Federal Register*.

NOTES

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2. Ibid, p. 212.
3. Ibid, p. 211.
4. Ibid, p. 193.
5. U.S. Federal Register, Vol. 49, No. 108, p. 23099.
6. Ibid, p. 208.
7. Ibid, p. 210.
8. Business Mexico, 1981, p. 198.
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10. Ibid. p. 210.
11. Federal Register, Vol. 49, No. 29, p. 5146.
12. Ibid., p. 5145.
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HONG KONG'S EXPORT AND DOMESTIC INCENTIVE PROGRAMS

ANNEX G

Unlike the other countries discussed in the annexes, Hong Kong does not employ a series of financial and fiscal instruments to promote exports. Instead, it has created an environment that is congenial to foreign investors and resourceful entrepreneurs. Following are brief descriptions of the factors that make Hong Kong an attractive environment for trade.

I. EXPORT INCENTIVES

A. Fiscal Instruments

1. Taxation on Income Earned Outside Hong Kong[1]

Income derived from foreign operations outside Hong Kong is not taxed, regardless of whether or not such income is remitted to Hong Kong. This includes dividends received, overseas income, and interest on foreign currency deposits.

2. Royalties

Foreign royalties are not taxed unless they arise from the use or the right to use in Hong Kong a patent, design, trademark, copyright material, manufacturing process, or formula.

B. Other Instruments

1. Export Credit Insurance Corporation[2]

The Hong Kong Export Credit Insurance Corporation was established in 1966 to facilitate trade by protecting exporters against otherwise uninsurable losses. These include insolvency of a buyer, government action in preventing or delaying payment to the policyholder, war or civil disturbance, imposition of import restrictions in the buyer's country, or the cancellation of a valid import license.

2. Exchange Controls[3]

Exchange control regulations were abolished in December 1972. In September 1973, when the sterling assets of banks ceased to be covered by the sterling guarantee arrangements, banks were free to employ their external funds in any currency. Companies thus have total flexibility in the movement of capital and the repatriation of profits. Funds invested in Hong Kong can be repatriated at will; dividends and interest are also freely remittable.

3. Restrictions on Foreign Ownership[5]

The government makes no distinction between local and foreign companies. The rule in Hong Kong is to allow private enterprise to play the dominant role in local development. There are no restrictions on the entry and expatriation of capital or on the conversion and remittance of profits and dividends.

4. Hong Kong Trade Development Council[6]

The Trade Development Council actively encourages foreign companies to establish commercial and industrial operations. This is accomplished through overseas promotional trips and branches abroad.

5. Industrial Land Policy[7]

The most important government policy that influences individual industries in Hong Kong is land policy. Virtually all land in Hong Kong belongs to the government and is sold by public auction; the purpose being to ensure that the land available will be used by those who are most efficient and can therefore afford the highest price at a particular sale of land. This is why the government does not control rent increases for industrial and commercial premises. The government takes great care in regulating the supply of land, and when there is a high demand the government tends to supply more land for sale so as to stabilize the market. Conversely, when the demand for land is low, the government usually reduces the supply of land for sale.

There are several ways in which the government has assisted industry through its land policy. First, from time to time, the government designates certain tracts of land for specific purposes and sells them to industries by way of private treaty. Thereby enabling those industries considered by the govenrment to be beneficial to the Hong Kong economy to obtain land at below the market price. At present, the government grants land for capital-intensive industries by way of private treaty, and large tracts of land for industrial estates.

A second form of government assistance occurs when better terms of payment are allowed for the purchase of industrial land. At one time, while the interest rate charged on the outstanding balance for the purchase of commercial and residential land was 10 percent annum, that for industrial land was only 5 percent.

The government has also asserted its control of land use through residential rent control, such that landlords are not permitted to increase rents beyond a certain limit. At present, the Rent Increase Control Ordinance is still in force and such rent contorl, as a form of price control, therefore prevents free market forces from operating.

6. Hong Kong has sophisticated port and shipping facilities and maintains a free-port status.

II. DOMESTIC INCENTIVES

A. Financial Instruments

Hong Kong does not have an industrial development bank, but the range of financial services available is wide and banks make short-term but renewable loans to industry, both for fixed and working capital to a much greater extent than in some economies.

B. Fiscal Instruments[8]

There are no specially-enacted incentives for domestic investment. Incentives are all inherent in the tax law itself, as follows:

1. Hong Kong has the lowest rate of corporation profits tax (currently 18.5 percent) among developed or developing countries in the Far East. This standard rate, which is also the maximum rate, applies irrespective of whether profits are distributed or whether the corporation is public or private. There is no surcharge on higher profits.

2. There is no capital gains tax, and the gains from the sale of shares that are not registered in Hong Kong are not taxed in practice.

3. Tax losses may be carried forward indefinitely and set off against any profits or trade, profession, or business carried on by the same entity. There is no continuity of ownership rule.

4. There is no withholding tax on dividends payable by resident companies to resident or nonresident shareholders.

5. Exemption from property tax may, upon application, be granted to any corporation that carries on a business in premises owned by the corporation. Any property tax paid by such a corporation may be deducted from the profits tax payable.

6. Depreciation written off in the accounts is not an allowable deduction. In substitution, capital depreciation allowances are granted at statutory rates on qualifying machinery and equipment, and industrial buildings and structures. The Commissioner may, at his discretion, allow a higher rate than that prescribed. The initial allowance is 55 percent of capital expenditure, and the annual allowances are at rates prescribed by the Board of Inland Revenue and computed on the declining value of the asset. The rates vary from 10 to 30 percent, according to the nature of the equipment.

C. Other Instruments

1. Freedom from Government Interference[9]

The government has constructed few barriers regarding approval for new investments and expansions. Actually the establishment of a local company is relatively simple. Enterprises are entirely free of government direction regarding decisions about productivity, investment, inputs, products, prices, and quantities.

2. Few Price Controls

Except for a price control on residential housing (vehicles being phased out) there are no significant price controls. The only exceptions are controls on public transportation charges, including bus, ferry, and tax fares.

3. An Abundant Supply of Labor

Hong Kong has an efficient labor force whose productivity has increased rapidly over time as a result of education, industrial training, and use of modern technology.

4. The Hong Kong Industrial Estates Corporation[10]

The government's special industrial land policy (also called "restricted land use policy") is considered to be an incentive for investors setting up in sectors that are regarded as particularly desirable for the development and diversification of Hong Kong's industry. The government has established industrial estates in which land is available at concessional prices to investors whose projects prohibit them from being carried out in ordinary multi-story industrial buildings and are not considered offensive trades under the Offensive Trades Regulations.

In 1984, a total of 38 companies set up in Taipo Industrial Estate and one established itself in the new Yuen Long Industrial Estate. An estimated HK $1.5 billion was invested by these 39 companies in land, buildings, equipment, and machinery.

The government is interested in attracting investment in medium and heavy engineering, such as the manufacture of hand tools, light machinery, automotive components, precision instruments, and other new high-technology fields.

Preference is given to applications for ventures in which the proposed industrial process will meet the following standards:

a) It will be new or will manufacture new products;

b) It will involve a higher level of technology than the colony's existing standard;

c) It will provide employment to highly skilled or technically trained personnel;

d) It will produce items for sale on the local market that are required by an existing industry;

e) It will manufacture many exportable products;

f) It will produce goods with a high value added from local content;

g) It will produce items of better quality and at a higher rate of productivity than those already available.

Criticism has been levied against the industrial estates in recent years. In the lease application, the firm must describe its products, manufacturing processes, and output levels. Once the Industrial Estates Corporation approves the application and the manufacturer signs a prelease agreement, construction of the factory may begin. The final lease, however, is signed only after the factory is completed and the manufacturer has complied with the statements in the lease application. Once the lease is signed, a company is required to get approval to make any changes from its contracted processes, products or output. Firms in high-technology fields complain that this requirements is limiting and restrictive.

Although payment terms were eased in 1983 and the corporation relaxed the criteria for land applications, few new enterprises have set up in the estates.

NOTES

1. Doing Business in Hong Kong, (Hong Kong: Price Waterhouse, 1983), p. 49.
2. Ibid, p. 14.
3. Ibid, p. 11.
4. Ibid.
5. Ibid.
6. Factors Which Hinder or Help Productivity Improvements Country Report--Hong Kong (Tokyo: Asian Productivity Organization, 1980), p. 72.
7. IL & T Hong Kong, (Business International Corp., August 1984), p. 3; and Lethbridge, David, ed. The Business Environment in Hong Kong (New York, NY: Oxford University Press, 1984), pp. 37-39.
8. Doing Business in Hong Kong. (Hong Kong: Price Waterhouse, 1983), p. 68.
9. APO Basic Research. Factors Which Hinder or Help Productivity Improvement (Tokyo: Asian Productivity Organization, 1980), p. 27.
10. IL & T Hong Kong, (Business International Corporation, 1984), p. 11.

SOUTH KOREA'S EXPORT AND DOMESTIC INCENTIVE PROGRAMS

ANNEX H

I. EXPORT INCENTIVES

A. Financial Instruments

1. 1972 Regulations for Export Financing

This program provides preferential short-term export financing to corporations. The maximum term of those export loans is 90 days and, unlike short-term domestic loans, they cannot be rolled over. Eligibility for preferential treatment is limited to the following:

a) Exporters in receipt of letters of credit;

b) Exporters concluding documents of acceptance or documents against payment contracts;

c) Exporters purchasing local supplies;

d) Exporters stockpiling raw materials;

e) Exporters with certificates based on past export performance;

f) Producers of raw materials for export; and

g) Companies awarded domestic projects based on international public tender.

Prior to June 1982, short-term export loans were charged a lower interest rate than short-term domestic loans. From June 1982 until January 1984, the Monetary Board established a uniform rate of 10 percent for both export and domestic short-term financing provided by commercial banks. Since January 1984, the Monetary Board has been liberalizing the interest rate structure by allowing banks to lend at lower than the uniform rate depending on the credit worthiness of the company.

In 1983, the rediscount ratios were 70 percent of face value on export loans and 30 percent of the face value of domestic loans for large firms and for those in the heavy and chemical industries. For small- and medium-sized firms (fewer than 300 employees), the domestic loan rediscount ratio was 70 percent. The present rate for both domestic and export short-term loans is 5 percent. Because of the higher discount ratio for export loans, banks tend to favor providing export loans rather than domestic loans to large companies.

The International Trade Administration (ITA) determined this program to confer a subsidy, as it favored primarily one group of manufacturers.

2. Short-term Loans for Exports of Agricultural and Marine Products[1]

The government provides loans for the collection or stockpiling of certain agricultural and marine products destined for export. The interest rate in 1984 was 10 percent and maturity could extend to 240 days for certain products.

The ITA does not consider this program to be countervailable, because loans at 10 percent interest rates are also available to domestic producers.

3. Medium/Long-term Foreign Currency Loans for Imported Capital Equipment and Raw Materials[2]

Banks dealing in foreign exchange are authorized to use foreign currency funds (within a ceiling) to help companies finance imports of capital goods and raw materials for certain industries, including export industries, defense, and other high-priority sectors. In certain cases, loans could be up to 100 percent of the import amount.

4. Export-Import Bank of Korea (KEXIM)

KEXIM, established in 1976, is South Korea's principal source of subsidized medium- and long-term import financing. KEXIM was intended "to promote the sound development of the national economy and economic cooperation with foreign countries by extending the financial aid required for export and import transactions, overseas investment and the development of natural resources." In addition to offering preferential loans, KEXIM also provides information on export markets and credit risk assessments.

KEXIM provides two types of export credit: 1) pre-delivery loans to cover the period of construction of the project; and 2) deferred export credits in the form of a post-delivery loan for ten years including a two-year grace period.

To be eligible for deferred export credit, the following criteria must be met by the exporter:

1. The contract on the sale must require a minimum 15 percent cash payment by the foreign purchaser;
2. The requested financing cannot exceed a 10-year period for loans greater than U.S. $1,000,000; and
3. The requested financing cannot be at interest rates below the KEXIM's lending rates.

For pre-delivery financing, interest is pre-paid quarterly, beginning at the time each principal installment is drawn down and extending throughout the life of the loan. Interest on the post-delivery loan is paid semi-annually on a retroactive basis. The principal of the pre-delivery loan is repaid in one lump sum at the time of acceptance of delivery. Post-delivery financing is repaid semi-annually over an eight-year period, beginning two years after disbursement of the loan. KEXIM requires the borrowers to obtain medium- and long-term credit risk insurance for post-delivery financing.

The ITA determined that this program in 1985 was countervailable as financing was contingent upon an exporting activity and the rates of interest were less than that on comparable commercial financing.

B. Fiscal Instruments

1. "Act Concerning the Regulations of Tax Reduction and Exemption"[3]

This act comprises, in part, 5 Articles that offer tax benefits to exporters. Articles 22, 23, and 24 provide taxable income deductions on reserve accounts related to export activities. These reserve accounts cover export losses, overseas market development losses, and price fluctuation losses. Articles 25 and 11 permit accelerated depreciation. Following are brief descriptions of the aforementioned articles.

a) Article 22

A corporation may establish a reserve amounting to one percent of foreign exchange earnings or 50 percent of net income in the applicable period, whichever is smaller. If certain export losses occur, they are offset from the reserve fund. If there are no offsets for export losses, the reserve is returned to the income account and taxed after a one-year grace period, over a three-year period.

b) Article 23

Under Article 23, a corporation may establish a reserve fund of one percent of its foreign exchange export earnings for the respective business year. Expenses incurred in developing overseas markets are offset from this reserve fund. Like the export loss reserve fund, if there are no offsets for expenses, the reserve is returned to the income account and taxed, after a one-year grace period, over a three-year period.

c) Article 24

Under Article 24, a corporation may establish a price fluctuation reserve fund equivalent to five percent of the book value of the products and work in progress that will be exported by the close of the business year. This reserve may be used to offset losses incurred from the fluctuation of prices for export goods, by returning an amount equivalent to the losses to the income account. If not utilized, the reserve is returned to the income account the following business year.

The balance in all three reserve funds is not subject to corporate tax, although all monies in the reserve funds are eventually reported as income, either when they offset export losses or when the one-year grace period expires. The ITA determines that these export reserve programs confer benefits that constitute export subsidies because they provide a deferral of direct taxes specifically related to exports. Because these export reserve funds are a one-year deferral of tax liabilities, the ITA treats them as an interest-free loan to the corporation equivalent to the tax savings on these funds.

d) Article 25

Article 25 allows a firm earning more than 50 percent of its total proceeds in a business year as foreign exchange to increase its normal depreciation by 30 percent. If the firm's export earnings fall short of 50 percent the role of accelerated depreciation is determined by a formula based on the ratio of its foreign exchange earnings to total business earnings. The ITA determined that this program is countervailable.

e) Article 11

Under Article 11, "a domestic person carrying on an important industry" can also increase normal depreciation by 30 percent. This article was used infrequently according to ITA documentation and it does confer a subsidy.

2. Customs Act--Article 28: Duty Abatement for Important Industries

The government allows reductions of import duties for certain industries on certain goods designated by the Ministry of Finance. Article 28 applies to machinery and equipment that cannot be properly manufactured domestically. The industries that usually have access to this incentive include the chemical industry, primary metal manufacture, general machinery manufacture, manufacture of transportation machinery, manufacture of scientific instruments, machine parts, and railroad transportation.

The ITA determined that this program conferred a bounty, because these tariff reductions on abatements "require designation and are not automatically available to all industries".

3. Customs Act of Korea--Article 36

Under Article 36, the Ministry of Finance can allow an industry to pay customs duties on an installment basis rather than upon entry. Prior to 1984, only industries designated by the Ministry of Finance were eligible for import duty deferrals and consequently the program was considered countervailable, as it was limited to a specific industry or enterprise. Currently the program is not determined to confer a subsidy because many industries have access to it.

4. Excess Customs Duty Drawback--Article 29[4]

The Duty Drawback Program is authorized under Article 29 of the Korean Foreign Trade Enforcement Ordinance. A South Korean firm importing raw materials or components for use in export products can receive a rebate, not only on the tariff paid on these imports, but also on the special consumption tax, the defense tax, and the value-added tax. Officially, these tariffs and taxes are suppose to be paid at the time of importation and rebated after the final product is exported. In practice, the importers usually take out a promissory note of 2 or 4 months that is then cancelled if exports are made within the specified period; if not, the South Korean firm must pay the tariff and taxes in cash upon maturity of the promissory note and collect its rebate at the time of export.

5. Corporation Tax Benefits[5]

Corporations involved with export articles have access to the following preferential tax arrangements:

a) Costs related to the exploitation of overseas markets may be treated as an expense for tax purposes;

b) The cost of maintaining mandatory reserve funds for export losses and price changes can also be treated as an expense for tax purposes;

c) The export of construction services, industrial plants, and overseas port services receive similar benefits, such as reserve funds for potential export losses and taxable income reduction on export earnings.

6. Special Consumption Tax[6]

There is an exemption from the consumption tax (5 to 100 percent) for exported goods.

7. Value-added Tax (VAT)[7]

The VAT system was introduced in July 1977; it replaced the former business activity tax and the commodity tax (as well as the petroleum products tax, the textile products tax, the electricity and gas tax, the transportation tax, the admissions tax, and the entertainment and restaurant tax). The VAT rate on export goods and for earnings derived from overseas services and overseas construction is zero.

The ITA has not investigated the VAT system.

8. Foreign Capital Inducement Law (FCIL) - Tax Privileges[8]

The South Korean Government approves tax benefits for foreign-invested projects that comply with national economic priorities. These projects are categorized as follows:

a) A project contributing significantly to improving the international balance of payments;

b) A project with advanced technology capability or large amounts of capital;

c) A project invested in by a non-resident South Korean national in accordance with the law concerning the Registration of Non-resident Korean Nationals;

d) Any other project designated by presidential decree as a project for which tax reduction of exemption is essential in order to induce foreign investment.

Under the FCIL, a foreign investor may choose either a direct corporate and dividend income tax exemption or a special depreciation. Investors selecting the five-year tax exemption may choose from any consecutive five-year period within ten years from registration of the enterprise. Tax exemptions and special depreciation awards are calculated as follows:

Income tax or corporation tax on a foreign-invested enterprise shall be exempt in proportion to the ratio of the stock or shares owned by foreign investors to the stock or shares of the enterprise concerned.

- The taxes on dividends accruing from the stock or shares acquired by a foreign investor are exempt for five years following the registration of the foreign-invested enterprise.
- The acquisition and property taxes on the properties acquired and held by a foreign-invested enterprise are exempt for five years from the date of registration in proportion to the foreign investment ratio of the enterprise concerned.

- Foreign employers are fully exempted from personal income tax for five years after the registration of the enterprise.

C. Other Instruments

1. General Trading Companies (GTC)

In 1975, the government created and sponsored general trading companies to consolidate South Korea's fragmented trading structures and to develop overseas markets and marketing techniques. Until 1980, a company with GTC status had access to benefits not extended to other exporting firms. These benefits included:

a) A priority in international bidding among South Korean firms for contracts controlled by the government;

b) Special benefits with regard to membership in exporters associations;

c) Use of standby letters of credit as revolving credit accounts;

d) Exemption from "end-users requirements" regulations that require imports of certain items to be accompanied by certificates documenting an immediate end-user need for the item.

GTC status was conferred on firms that accounted for at least 2 percent of South Korea's total exports in the previous year, exported at least 4 items earning more than 1 million US$, and had 20 or more branches overseas. In 1984, nine Korean firms were assigned GTC status.

Since 1980, GTC designation has provided no special benefits except the prestige of the GTC label. Part of the reason for the withdrawal of benefits was due to the overall poor financial structure of South Korea's conglomerates.

The ITA does not consider this program to confer a subsidy.

2. Special Export Promotion Fund[9]

A special import tax of 0.24 is charged on all imports, except those meant for the Korean Government, defense industries, or re-export. The Korea Traders Association, a government agency, distributes the revenues from this surcharge to a wide range of export promotion activities such as trade fairs, exhibitions, and other market development programs.

3. Duty-Free Export Zones[10]

There are two free trade export zones in South Korea: the Masan Free Export Zone near Pusan and the Iri Free Export Zone in North Cholla Province.

The benefits provided are intended to encourage foreign investment and promote exports. To qualify for entrance into one of these zones, enterprises must produce exclusively for the export market. (According to the ITC publication which this program is cited, this restriction is to be eased.) Companies operating in the zones can be either foreign or South Korean-owned.

Several benefits are provided to firms located in the duty-free export zones. They include:

a) Exemption from tariffs, defense tax, special consumption tax, and VAT on all imports of raw materials, capital goods, and semi-finished goods;

b) Exemption from corporation tax, property tax, and property acquisition tax for the first five years;

c) Zero rate of the VAT on exported output;

d) Exemption from taxes on dividends and surplus distribution accruing to foreign investors during the first five years;

e) Exemption from income taxes during the first five years for salaries of foreigners having specified job experience or academic backgrounds. This exemption is not intended to promote exports, but to develop technology;

f) Loan terms that are generally available to exporters in South Korea;

g) Exemption from inspection procedures for export products;

h) Simplified customs procedures;

i) Access to industrial infrastructure facilities.

This program was determined by the ITA to confer a subsidy.

4. Preferential Port Rates

Under the Iron and Steel Industry Rehabilitation Order, "designated companies" are eligible on a case-by-case basis to receive discounts on port rates.

The ITA determined that this program is countervailable.

5. Wastage Allowance System

The Wastage Allowance System has been one of the most important export incentives. High-grade materials which can be imported only if used as inputs for export production are assigned an 0.5 percent to 10 percent "wastage allowance." This allows exporters to sell so-called "wasted" raw materials at a very high profit domestically, providing them with a supplemental income. In those U.S. CVD cases in which wastage was cited, it has usually been found not to be excessive.

II. DOMESTIC INCENTIVES

A. Financial Instruments

1. National Investment Fund (NIF)[11]

The NIF, established in 1973, has played a significant role in developing priority industries in South Korea. The primary objective of the fund was to encourage national savings and to supply the investment and loan funds needed to promote major industries. Low-cost financing was specifically targeted to the steel, nonferrous metal, shipbuilding, machinery, chemical, electronic, food production, and cement industries. Funds were also available for projects that increased rural incomes and developed fishing and fisheries projects.

In 1982, preferential interest rates were officially abolished for most major NIF loans. However, certain activities are still receiving preferential interest rates. They include public housing loans (8 percent interest rate), national housing lottery fund loans (4 percent interest rate), and funds for irrigation (5.5 percent interest rate), compared with 10 to 10.5 percent commercial market rates.[12]

Currently, NIF loans go primarily to the heavy, chemical, electronics, and electric power industries, and to agricultural projects. These funds are provided at variable long-term interest rates through such intermediaries as the Korean Development Bank, the Export-Import Bank of Korea, and other banking institutions.[13] Since NIF funds have been allocated primarily through development institutions, NIF loans account for only a small proportion of total lending for the commercial and specialized banks.

In 1981, the NIF provided 606.7 billion won in funds (54.9 percent of these funds went to the heavy and chemical industries), 730 billion in 1982 (61 percent to heavy and chemical industries), and 732.6 billion in 1983 (65 percent to heavy and chemical industries).[14] In 1984, the size of the NIF was reduced by about 25 percent, to 550 billion won. Of this amount, 67.3 percent was for allocation to the heavy and chemical industries, and 18.2 percent was planned for exports on a deferred payment basis. Further reductions in the size of the NIF are planned in coming years.

The ITA determined that if the NIF provided loans at preferential interest rates to exporters, then the program was considered to confer a countervailable subsidy.

2. The Korea Development Bank (KDB)[15]

The KDB was established in 1954 to supply long-term credit for major industries. During the late 1950s, the KDB concentrated on the rehabilitation of industrial facilities destroyed during the Korean war. The bank currently specializes in supporting development projects in major industries and industrial infrastructure. Most of the bank's loans are concentrated in the electric power, coal mining, shipbuilding, iron and steel, and other major industries designated by the Government.

In addition to offering loans, the KDB subscribes to and underwrites corporate stocks and debentures, and makes payment guarantees to help finance major industrial projects. The KDB also engages in foreign-exchange business and operates special funds such as the Shareholding Administration Fund, the Industrial Rationalization Fund, and the Energy Rationalization Fund.

The share of KDB loans to heavy and chemical industries increased from 24.3 percent in 1972 to 47.1 percent in 1980. In 1983, KDB's share of these loans decreased to 412.5 percent.

3. Korea Long-Term Credit Bank[16]

The Korea Long-Term Credit Bank (formerly the Korea Development Finance Corporation) was established in 1980, as a financial intermediary to meet demand for long-term credit. Currently, its major activities include the extension of medium- and long-term finance for the purchase of equipment and working funds.

At the end of September 1982, the bank's assets stood at 250.2 billion won, and loans totaled 610.3 billion won.

This program is not considered by the ITA to be countervailable.

4. Korea Credit Guarantee Fund (KCGF)[17]

The KCGF was established in 1976 to provide credit guarantees for businesses unable to obtain financing from other financial institutions. In addition to credit guarantees, the fund provides credit information, management and technical assistance, and guarantees the repayment of loans, discounts, commercial bills, and corporate debentures.

In 1983, credit guarantees were provided for 11,422 manufacturing businesses, amounting to over 72 percent of the total. Metal assembly machinery represented 17.9 percent; chemicals, coal, petroleum and rubber made up 13.2 percent of credit guarantees; and textiles and clothing comprised 15.2percent of the total share of funds.

5. Korea Technology Development Corporation (KTDC)[18]

The KTDC was established in 1981 to promote the technical development of private enterprises. Projects eligible for KTDC financial support are R & D activities for the development of new products and the improvement of existing ones, the import of new technologies, and the manufacturing and mandating of new products.

The ITA has no official position on this program.

B. Fiscal Instruments

1. "Article 72 of the Tax Exemption and Control Law" (until 1982 under Article 24-5 of the Corporation Tax Act)[19]

This program, administered by the government, provides special investment tax credits on a case-by-case basis, if the government decides that a particular investment is needed. This tax credit covers investments made by small- and medium-sized enterprises in machinery and equipment used directly for manufacturing and mining purposes.

The ITA claims this program is countervailable as its implementation was preferential.

C. Other Instruments

1. Wage Controls

The government controls wages for government-run firms. Complainants filing a U.S. countervailing suit against South Korean exporters argue that South Korean exporting firms have lower production costs because of this incentive.

The ITA has determined that this program is not countervailable, as it is available to all industries.

2. Preferential Utility Rates

Under Article 7 of the Iron and Steel Industry Promotion Act, companies can receive, on a case-by-case basis, discounted utility charges.

This option was not used by any of the companies investigated by the ITA.

3. Government Equity Infusions

The South Korean government has a substantial participation in the ownership of various companies.

The ITA consistently maintains that government provision of equity does not per se confer a subsidy: "government equity purchases bestow countervailable benefits only when they occur in terms inconsistent with commercial considerations."[20]

SOUTH KOREAN COUNTERVAILABLE SUBSIDY PROGRAMS UNDER U.S. LAW
1983-1986

PROGRAM NAME	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Accelerated Depreciation	1979	Rubber and Non-rubber Footwear	de minimus
	1983	Bicycle Tires and Tubes	0.03
	1984	Steel Shapes and Sheet	2.41
		Oil Country Tubular Goods	0.03
	1985	Offshore Platform Jackets and Piles	0.15
Foreign Capital Inducement Law	1983	Bicycle Tires and Tubes	0.94 0.01
Free Export Zones	1979	Rubber and Non-rubber Footwear	de minimus
	1982	Steel Wire Nails	0.0005
		Welded Carbon Steel Pipes & Tubes	1.72
Government Equity Infusion	1984	Steel Shapes and Sheet	0.71
Preferential Financing--Export-Import Bank	1985	Offshore Platform Jackets and Piles	9.4 3.91
Preferential Short-Term Export Financing under the Export Financing Regulations	1977	Handbags	de minimus
	1979	Rubber and Non-rubber Footwear	de minimus

PROGRAM NAME	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
	1983	Bicycle Tires and Tubes	0.11 0.46
	1984	Steel Shapes and Sheet	0.33
		Oil Country Tubular Goods	0.46
Preferential Export Financing (Government of Korea)	1982	Steel Wire Nails	0.32
		Welded Carbon Steel Pipes and Tubes	1.16 0.52 0.52 0.60
Preferential Port Charges	1984	Oil Country Tubular Goods	0.05
		Cold Rolled Carbon Steel Flat-Rolled Products	N.A.
Preferential Utility Rates	1982	Welded Carbon Steel Pipes and Tubes	0.05
Tariff Incentives	1982	Welded Carbon Steel Pipes and Tubes	0.05
Tariff Reduction on Imported Plant & Equipment	1984	Steel Shapes and Sheet	0.10
Tax Exemptions for Government-Owned Firms	1982	Welded Carbon Steel Pipes and Tubes	0.46
Tax Exemptions for Steel Producers	1982	Welded Carbon Steel Transmission and Certain Steel Products	N.A.

PROGRAM NAME	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Tax Incentives for Exporters	1982	Steel Wire Nails	0.11
		Welded Carbon Steel Pipes and Tubes	0.09
			1.45
			1.45
			1.31
	1984	Oil Country Tubular Goods	0.04
		Steel Shapes and Sheets	0.005
Tax Incentives under Articles 22, 23, and 24	1977	Handbags	de minimus
	1979	Rubber and Non-rubber Footwear	de minimus
	1985	Offshore Platform Jackets and Piles	0.16
			0.08

Source: This table is comprised of information obtained from the testimony and findings on CVD cases in the Federal Register and U.S. Department of Commerce, Subsidies Library.

NOTES

1. United States International Trade Commission. Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan. USITC Publication 1632, (Washington, D.C.: USITC, January 1985), p. 159.

2. Ibid.

3. Descriptions are derived from announcements in Federal Register, Volume 49, No. 112, 18 Sept. 1984, p. 36542.

4. U.S. International Trade Commisson, Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico and Taiwan, USITC Publication 1632 (Washington, D.C.: January 1985), p. 132.

5. Ibid, p. 144.

6. Ibid.

7. Ibid.

8. Ibid, p. 146.

9. U.S.International Trade Commission, Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico and Taiwan, USITC Publication #1632 (Washington, D.C.: USITC, January 1985), p. 159.

10. Ibid, p. 145.

11. United States International Trade Commission. Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico and Taiwan, USITC Publication 1632 (Washington, D.C.: USITC January 1985), p. 152.

12. Ibid.

13. Ibid, p. 154.

14. Ibid, p. 155.

15. Ibid, p. 151.

16. Ibid, p. 152.

17. Ibid, p. 154.

18. Ibid, p. 152.

19. Ibid.

20. Federal Register, Vol. 49, No. 182, 18 September 1984, p. 36542.

SINGAPORE'S EXPORT AND DOMESTIC INCENTIVE PROGRAMS

ANNEX I

I. EXPORT INCENTIVES

A. Financial Instruments

1. Pre-export and Export Financing through the Monetary Authority ofSingapore (MAS)[1]

The Monetary Authority of Singapore's rediscount facility makes available funds for pre-export and export financing at favorable interest rates, through the exporter's bank. The loan, generally issued for a maximum period of three months, may be extended for another three months. The discount rate, stipulated by MAS, is generally 2-3 percentage points below prevailing prime rates. Negotiating banks are allowed to charge a maximum commission of not more than 1.5 percent. The ITA has determined that these loans were countervailable, because the interest rates charged were below commercial rates. The ITA and government of Singapore concurred on a suspension agreement that prohibits any Singapore firm under U.S. investigation from receiving any financing from the MAS. This suspension agreement was offset completely with an export charge equal to the net bounty calculated by the Department of Commerce.

2. The Export Credit Insurance Corporation (ECICS)[2]

The Export Credit Insurance Corporation, a joint government-private enterprise, provides credit insurance coverage against non-payment of export credits caused by political and/or commercial factors. Insurance is available to exporters, merchants, finance houses, and banks.

Broadly, the export credit insurance facilities can be grouped into two categories: comprehensive coverage and specific coverage. The distinction between the two lies in the nature of the goods or services to be insured and the length of credit involved.

a) Comprehensive Policies are generally suitable for exporters who are engaged in the export of goods and services that are repetitive and where the credits are normally not longer than six months.

b) Specific policies are more suitable for the export of capital and semi-capital goods or services that are non-repetitive and involve credits in excess of one year.

The risks insured under the comprehensive policy or specific policy are identical, with the exception of "repudiation" and "omnibus" risks that apply only to the comprehensive policy.

3. Guarantees to Banks[3]

As a supplement to its comprehensive and specific credit insurance policies, ECICS also offers direct guarantees to banks. These guarantees provide a 100 percent unconditional indemnity to the bank funding an export credit. As is the case with the credit insurance policy, two types of bank guarantees are available - the comprehensive bank guarantee and the specific bank guarantee.

4. Buyer Credit Guarantees[4]

ECICS' buyer credit guarantee provides 100 percent unconditional indemnity to the funding bank that makes loans to an overseas borrower to finance the purchase of capital goods.

B. Fiscal Instruments

1. Tax Exemption on Interest on Approved Foreign Loans[5]

There is tax exemption on interest withholding tax on approved foreign loans for purchase of productive equipment.

2. Duty-Free Import of Equipment[6]

Machinery, equipment, and raw materials not obtainable locally for industrial enterprises in Singapore may be imported free of duty on application to the Customs and Excise Department.

3. Warehousing and Servicing Incentive[7]

This incentive is specific in its application to warehousing operations that include some degree of servicing, e.g. warehousing and repair of tractor parts. It may also apply to projects that satisfy the requirement of $2 million fixed investment and that mainly provide technical or engineering services.

It allows a reduction of company tax from 40 percent to 20 percent on profits derived from export sales or export services in these operations above a specified base, for five years.

4. Export Incentive[8]

This incentive provides for a concessionary tax rate of 4 percent on export profits instead of the normal 40 percent rate on company profits. It may be granted in selected cases where the award of pioneer status may not be justifiable but the government wishes to provide favored treatment.

The tax concession period is normally for five years. Fifteen years may be granted for projects with fixed capital expenditure no less than $150 million, provided 50 percent of the company's paid-up capital is held by Singapore permanent residents or for projects with fixed capital expenditure of no less than $1 billion.

Generally, to qualify for this export incentive, export sales must be not less than $100,000 in the export year, and at least 20 percent of total sales. Export performance alone does not automatically qualify a project for export incentive. Level of fixed investment, technology, and skill are considered.

5. Concessionary Tax Rate on Export Profits

This scheme is meant for trading companies that export Singapore-manufactured products or produce or non-traditional commodities. Non-traditional commodities are primarily products other than tin in the form of ore, ingots or slabs; natural rubber; crude palm oil; palm kernels; palm kernel oil; crude coconut oil; copra; coconuts; logs; sawn timber; crude petroleum; petroleum products; spices; pepper; and such other commodities as may be excluded by notification in the Government Gazette.

This incentive offers a concessionary company tax rate of 20 percent on export profits for five years. The tax concession is computed in a similar manner as that for the warehousing and servicing incentive, except that the base export sales level is computed on a moving average basis over the preceding three years instead of being on a fixed base.

Companies must either export a minimum of $10 million per annum of qualifying manufactured products or Singapore domestic produce, or a minimum of $20 million per annum of non-traditional commodities.

6. The Trade Development Board (TDB)[9]

The Trade Development Board was founded on 1 January 1983, is the major establishment responsible for promoting and representing Singapore's international trade interests. It accomplishes its objectives through a series of operations that provide services and incentives to exporters. These schemes include exporter services, trade publicity, trade information services, shipping and transport, trade fairs and missions, trade documentation, and overseas centers. Under several of these schemes, promotion and representation expenses have enjoyed a double deduction from income taxes. The ITA has determined that these deductions are countervailable. The following descriptions provide more detail on each of the programs listed above.

a) Exporter Services

TDB provides a market advisory service for Singapore's exporters. It assists those with potential to market overseas and those already exporting either to gain a bigger share of the market or to penetrate new markets.

b) Trade Publicity

The Trade Publicity Service was set up to publicize TDB's trade development activities and to promote the image of Singapore's product overseas. Primarily, it plans, develops, and implements a publicity program that involves publication, press, and other media activities targetted at local and foreign audiences.

c) Shipping and Transport

TDB provides information on freight rates and availability of shipping services to different countries for exporters. It also monitors developments in regional and international shipping and adopts appropriate measures to assist shippers and shipments.

d) Double Deductions of Export Promotion Expenses[10]

This program allows the double-deduction of approved expenses incurred in the overseas promotion of Singapore-made products. Any company undertaking the following promotion activities is eligible for the benefit:

- Participation in an overseas trade fair, trade exhibition, and trade mission;
- Participation in an approved trade fair or exhibition;
- Maintaining an approved overseas trade office;
- Overseas market development programs; and
- Advertising in an approved publication.

Every company is allowed a single deduction for promotional expenses, but since the double deduction is available only to exporters, the ITA found this program countervailable under U.S. Countervailing Law.

e) Trade Documentation

TDB processes declarations for the import and export of goods. It also issues certificates of origin. The certificates are issued to satisfy buyers that the goods exported are manufactured in Singapore. They also enable exporters to apply for the various schemes of preferences--Generalised System of Preferences, ASEAN preferential trading arrangements and commonwealth preferences.

f) Overseas Centers

TDB's overseas centers provide a range of basic services aimed at facilitating contacts between Singapore exporters and overseas businessmen. They initiate contacts and leads for Singapore exporters, co-ordinate Singapore participation at trade fairs and missions, and provide information on trade developments and export opportunities in their host countries.

In line with this program, the Government of Singapore offers a double-tax deduction scheme for overseas trade offices. This scheme is designed to encourage Singapore companies to set up trade offices overseas to promote the export of Singapore manufactured goods.

A company whose overseas trade office is designated as an approved overseas trade office is entitled to double-tax deduction for the expenses incurred in maintaining the office. Double-tax deduction is allowed for the first two years of operation of the office. The amount of expenses eligible for double-tax deduction is subject to a limit to be determined by the Trade Development Board.

7. International Consulting Services Incentive

This incentive is intended to encourage Singapore-based consulting firms and engineering contractors to export their services to overseas markets. Services eligible for this incentive include project management and supervision, design and engineering, plant fabrication and procurement of materials and equipment, and computer and data processing services.

This incentive allows for a five year reduction of company tax from 40 percent to 20 percent on export profits in excess of pre-determined base levels.

8. Economic Expansion Incentives Act--Part IV

Part IV of the Economic Expansion Incentives Act enables the Minister of SEDB to approve any product manufactured in Singapore as an export product. The Minister may also issue an export enterprise certificate to any company manufacturing or proposing to manufacture an export product. Once export profits have been determined, an amount equal to ninety percent of export profits can be exempt from tax.

The ITA determined that Part IV does confer a countervailable subsidy because benefits are extended to exporters only.

C. Other Instruments

1. Import Licensing[11]

Most goods can be imported freely. Import licences are required for all goods originating from Albania, East Germany, North Vietnam, People's Republic of Mongolia, and People's Democratic Republic of Laos. Rice, refined sugar, and air-conditioners not exceeding 9000 kcal/h (except for motor vehicles) from all countries are also subject to import licensing.

II. DOMESTIC INCENTIVES

A. Financial Instruments

1. Small Industries Finance Scheme (SIFS)[12]

The Small Industries Finance Scheme introduced by the Singapore Economic Development Board, provides fixed interest funds to small locally-owned enterprises. It is operated jointly by the SEDB, the Development Bank of Singapore, the Oversea-Chinese Banking Corp. Ltd., Hong Leong Finance Ltd., the Chartered Bank, the Overseas Union Bank, the United Overseas Bank and the Tat Lee Bank.

To qualify for SIFS loans, applicants must be engaged in the manufacturing or in the provision of supporting services, eg. electroplating, heat treatment. They should not have more than $2 million in fixed productive assets, i.e., factory buildings, machinery, equipment, and tools.

Loans applied for under the scheme must be for one or more of the following purposes: establishing viable new small enterprises, encouraging modernization of plant and machinery, expanding existing production, diversifying into other product lines, and providing working capital to existing viable projects in need of funds.

Types and Quantum of Loans:

a) Factory Loans: Up to 85 percent of cost for standard factory buildings and 70 percent for non-standard factory buildings, for up to ten years, inclusive of a grace period of up to three years.

b) Machinery Loans: Up to 70 percent of cost and eight years' duration inclusive of a grace period of up to two years for term loans. For hire purchase and financial leasing up to 80 percent of cost--up to four years for hire purchase, and up to five years for financial leasing.

c) Working Capital Loans: If progressively retired, maximum of two years including up to six months grace period. For contract financing packing credit, maximum of one year.

The value of buildings and machinery is based on valuation or purchase price, whichever is lower.

The maximum amount of loan for any one applicant is $2 million. The interest rate for the scheme is nine percent p.a.

The ITA found that there is no limitation on the companies that receive financing under this program, therefore this program does not confer a bounty.

2. Product Development Assistance Scheme[13]

The SEDB administers a dollar-for-dollar grant targeted to local manufacturing companies for the development and/or improvement of products or processes. Funds can be used for payment of "direct costs" which can also include utility, manpower, material, and tooling costs. Under the Scheme, the government and the company equally bear the direct cost of the project. The maximum grant per project is $200,000, which is disbursed in stages subject to satisfactory progress at each review stage of the project.

To be eligible for the grant, applicants must comply with certain criteria:

a) Applicants must be Singapore companies with majority shareholding by Singapore citizens or permanent residents.

b) Applicants are required to have a track record in developing and commercializing products or processes.

c) The project should be closely related to the applicant's existing manufacturing activities and should involve substantial technical improvements to the product or process.

3. Capital Assistance Scheme[14]

The Singapore Economic Development Board (SEDB) provides equity and/or fixed cost loans to specialized projects of economic and technological benefit to Singapore.

Under the equity participation program, the SEDB will provide up to 50 percent of the equity capital required for an approved program. Any time during the first five years a company can re-purchase its share at no less than the stock's par value.

In place of equity or in addition to it, loans either directly from SEDB or through an approved bank can be extended to a specific group of enterprises or industries targeted by the government. Firms can receive financing for up to seventy percent of fixed assets (building, plant and machinery), for five to ten years, with an appropriate grace period for repayment of principal.

4. Government Ship Financing Scheme

Under the Government Ship Financing Scheme, buyers of ships and rigs have access to long-term fixed rate credit. For ships constructed in local yards, the government is generally prepared to finance up to 80 percent of the contract value for foreign shipowners and up to 85 percent for Singapore-registered shipping companies at an interest rate of 10 percent in Singapore dollars (12 percent in US dollars). For rigs, the government is prepared to finance up to 50 percent of contract value at 10 percent in Singapore dollars (13 percent in US dollars). Maximum credit in all cases is $20 million, and the repayment period is eight and a half years after delivery for foreign shipping companies and ten years for local buyers.

B. Fiscal Instruments

1. Tax Relief for Pioneer Industries--Economic Expansion Incentive Act (Part II)[15]

To encourage the establishment of factories, the Minister for Finance may, "if he considers it expedient in the public interest to do so, by order declare an industry, which is not being carried on in Singapore on a scale adequate to the economic needs of Singapore and in which in his opinion there are favourable prospects for development, to be a pioneer industry and any specific product of that industry to be a pioneer product". Companies which produce a pioneer product may be approved by the Minister as a pioneer enterprise and thereby become entitled to exemption from company tax (40 percent) for five to ten years from the date they commence commercial production.

A company with pioneer status is exempt from paying taxes on company profits for five to ten years. The length of pioneer period depends on the merits of the project according to investment, skills, and technology level and also gestation period of project, e.g., manufacture of machine tools. Specialized projects manufacturing new and desirable products can be considered for pioneer status even if fixed investment is small. Pioneer certificates can be issued to more than one company manufacturing the same products.

2. Investment Allowance (Part VIA of the Economic Expansion Incentives Act)[17]

This is a tax exemption for up to a maximum of 50 percent of the outlays on approved new investments in plant, machinery, and factory buildings.

Companies can receive the investment allowance if the investment meets one of the following criteria:

- The investment results in greater efficiency in resource utilization;
- The investment introduces new technology into an existing industry;
- The project is significantly more efficient in resource utilization than the industry average; or
- The project produces parts and components used by other industries.

Because the program is not limited to a specific enterprise or industry, or group of enterprises or industries, the ITA determines that this program does not constitute a bounty or grant.

3. Expansion Tax Incentive

A manufacturing enterprise that increases its investment in productive equipment by no less than $10 million, may be granted tax exemption on the increase of income resulting from the expansion, for a period of up to 5 years.

4. Accelerated Depreciation Allowance[17]

Beyond the normal initial depreciation allowance on capital expenditure on machinery or plant, accelerated initial allowance of 25 percent and annual allowance of 33.33 percent for three years may be claimed. Accelerated depreciation allowances for industrial buildings can be depreciated over 25 years.

5. Exemption of the Public Utilities Board Surcharge

Exemption from a government surcharge on electricity bills is available to manufacturing companies that use more than 100,000 kwh of electricity per month. To receive the exemption, a company must show an improvement in energy efficiency from one year to the next or invest an amount equal to or greater than fifteen percent of its total annual energy cost in energy-saving equipment.

The U.S. ITA found that the government of Singapore did not discriminate in favor of or against a particular company or industry, and therefore this incentive does not provide a countervailable benefit.

C. Other Instruments

1. Skills Development Funds (SDF)[18]

The Skills Development Fund, operated by the SEDB's Manpower Division and founded in 1979, offers three financial incentive schemes: the Training

Grant Scheme, the Interest Grant for Mechanisation Scheme; and the Development Consultancy Scheme. It is funded through a levy on all employers equal to four percent of the salary of all employees earning less than $750 per month.

The Training Grant Scheme provides grants for training programs that will upgrade employee skills. It subsidizes between 30 to 90 percent of the costs for approved training programs.

The Interest Grant for Mechanisation Scheme provides grants for the re-equipment of plants with new machinery. The new equipment should lead to savings in labor usage, an increase in productivity, or the introduction of more sophisticated or skilled operations. The fund subsidizes fifty percent of interest cost incurred in purchase of equipment for automation.

Finally, the Development Consultancy Scheme subsidizes thirty to seventy percent of the cost local companies incur in using short-term experts to analyze specific operations for upgrading.

According to ITA investigations, the Fund applies the same standards for giving grants to all businesses and there is no evidence of discrimination in favor or against a particular company or industry. Therefore, the ITA determined that these programs do not constitute countervailable benefits.

2. Research and Development[19]

R and D incentives are available to manufacturing companies engaged in research and development. Specialized research and development institutions servicing manufacturing companies are also eligible for certain incentives.

For approved projects, the incentives include:

a) One or more years of pioneer status;

b) Investment allowance of up to 50 percent of the capital investment in R & D, excluding the cost of buildings;

c) Double deduction of R & D expenditure, other than on buildings and equipment;

d) Capitalization and writing-off of lump sum payments for manufacturing licences over a five year period;

e) Accelerated depreciation over three years for all plant and machinery used for R & D;

f) Extension of the initial capital allowance on tax depreciation of 25 percent and annual allowance of three percent presently available only to industrial buildings and structures to R & D buildings;

g) Complete exemption or reduction to 20 percent of withholding taxes non-residents pay for royalties, technical assistance fees or contributions in R & D.

3. Special Incentive for Foreign Investors[20]

a) Concessionary Tax Arrangements for Non-Residents

There are no restrictions on the remittance of interest earned by non-residents on accounts with Singapore banks. This interest is not liable to Singapore tax, provided the recipient is a non-resident for tax purposes. Non-resident deposits with Asian Currency Units and approved Asian Dollar Bonds and Singapore Government tax-free bonds held by non-residents are exempt from Singapore estate duty. From 1 April 1983, all income derived by the Asian Currency Units of banks and financial institutions in Singapore from loans syndicated in Singapore within the next five years and for such further period as the Minister of Finance may approve, shall be exempt from tax, provided they fulfill required conditions.

b) Property Tax Relief

A concessionary 12 percent instead of the full property tax rate for a period of 20 years is applicable to facilities, erected in areas designated for urban redevelopment, provided the properties are "approved development projects". In addition, the owner may, on completion of an approved project, apply for a refund of property tax paid for the period of six months from the date of approval of the project, plus an additional one month for every story of buildings erected.

SINGAPORE'S COUNTERVAILABLE SUBSIDY PROGRAMS UNDER U.S. LAW 1983-1984

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Double Deduction of Export Promotion Expenses	1984	Certain Textiles, Mill Products and Apparel	0.001
The Economic Expansion Incentives Act-Part IV	1983	Refrigeration Compressors	4.74
Monetary Authority of Singapore Rediscount Facility	1983	Refrigeration Compressors	0.13
	1984	Certain Textiles, Mill Products, and Apparel	0.005 0.013

Source: Federal Register, Volume 50, No. 240, 13 December 1985, p. 5093; Ibid., Volume 50, No. 215, 6 November 1985, p. 46148; Ibid., Volume 50, No. 144, 26 July 1985, pp. 30493-30495; Ibid., Volume 50, No. 30, 13 February 1985, pp. 6025-6026; Ibid., Volume 48, No. 221, 15 November 1983, p. 51496; Ibid., Volume 48, No. 168, 29 August 1983, pp. 39109-39112; and Ibid., Volume 50, No. 48, 12 March 1985, pp. 9840-9845.

NOTES

1. Investor's Guide, (Singapore: Singapore International Chamber of Commerce, July 1983) p. 47.

2. Ibid.

3. Ibid., p.48.

4. Ibid., p.49.

5. Ibid., p.42.

6. Ibid., p.54.

7. Ibid., p.41

8. Ibid., p.45

9. Ibid.; and Singapore Trade Development Board (1983/84) Annual Report (Singapore: Trade Development Board, 1985).

10. Federal Register, Volume 50, No. 48, 12 March 1985, p. 9841.

11. Investor's Guide, (Singapore: Singapore International Chamber of Commerce, July 1983).

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15. Ibid., p.40.

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TAIWAN'S EXPORT AND DOMESTIC INCENTIVE PROGRAM

ANNEX J

I. EXPORT INCENTIVES

A. Financial Instruments

1. The Export-Import Bank of China (TEXIM)[1]

TEXIM was established in January 1979 to provide medium- and long-term credits to finance exports of machinery, equipment, and capital goods, and to underwrite imports of raw materials and technical services. Other services provided by the bank include: preshipment and short-term export credits for purchases from small- and medium-sized machinery producers in Taiwan and insurance against buyer default for all types of goods.

TEXIM interest rates are comparable to those prevailing under the OECD Export Credit Arrangement; in 1984, they were 1.5 percent above the interbank rate in Taiwan. The principal recipients of its financing have been the industrial machinery, machine tool, shipbuilding, steel, textile, food processing, and plastic industries. TEXIM accounted for roughly 37.2 percent of the direct export loans given by domestic banks in 1983. Another 34 percent of domestic export loans carried payment guarantees by TEXIM.

2. Export Loan Discount Regulations[2]

The Export Loan Discount Regulations of the Central Bank of China permit registered exporters in possession of a letter of credit to apply for low-cost export loans covering up to 85 percent of the value of the export transaction. Export loans are arranged through authorized foreign currency banks, which may apply for an interest-rate reduction from the Central Bank. Exporters settle the loan with foreign exchange within 180 days or pay an interest-rate penalty on the full amount of the loan.

The International Trade Administration (ITA) determined that these loans confer a bounty because they are contingent upon export performance and provide funds to borrowers at interest rates lower than those available for other purposes.

3. Article 84[3]

Article 84 of the Statute for the Encouragement of Investment (SEI) permits the Executive Yuan to establish and administer a special development fund to promote investments of interest to national economic development.

The ITA does not have an official position regarding this incentive, as the program was not used by any of the Taiwan firms under investigation.

B. Fiscal Instruments

Since 1960, tax policy has been one of the most important methods used by the Taiwan authorities to achieve industrial policy goals. Today, the authorities use the tax system to encourage production of high value-added goods, to underwrite productivity-improving investments, and to reward export-oriented firms.

The SEI is the principal vehicle by which the authorities attempt to shape private investment decisions. It spells out specific tax incentives and lists eligibility requirements that are updated frequently to reflect changes in industrial policy and market conditions.

The authorities use two approaches to promote industry through the tax system. First, they provide incentives to firms displaying good growth potential. The specific eligibility criteria for such tax incentives are spelled out on an industry-by-industry basis and are available for exporting, achieving economies of scale, increasing domestic content, or upgrading production technology.

The second approach to using tax incentives involves designating "strategic" industries. Unlike the above approach, which may apply to a few firms in most industries, this approach applies to most firms in a few selected industries. These industries can broadly be described as growth industries with export potential such as automobiles, computers, electronics, and machinery.

Firms that fall into these two categories qualify for numerous tax benefits, including up to 9 years of exemption from corporate income taxes rebates of import duties and excise taxes.

Many of the general tax benefits provided in the Statute are rarely used. For example, those for investments in natural resources, pollution prevention equipment, machinery renovation, public stock offerings, research and development, and mergers are rarely taken advantage of by firms. On the other hand, export tax incentives are used extensively. In 1983, over 1.4 million firms qualified for tax benefits because of their direct or indirect export activities. Over US$ 166 million in taxes were foregone for this purpose in 1983. The following section describes some of the prevalent tax incentives utilized by firms for export related activities.[4]

1. Article 31[5]

Article 31 of SEI enables exporters to establish an export loss reserve of up to one percent of the previous year's export exchange settlement, to be used exclusively for compensating export losses. Companies treat the export loss reserve as a business expense and deduct it from taxable income in one year, then balance the account and carry the reserve funds forward as taxable income for the next year.

In 1983, 137 firms took advantage of this incentive which amounted to approximately US $22,332 in foregone taxes.

Because the export loss reserve is contingent on export sales, the ITA determines that Article 31 confers a benefit that constitutes an export subsidy.

2. Article 15[6]

Article 15 of SEI permits productive enterprises and big trading companies to pay no more than 25 percent corporate income tax on income exceeding NT $500,000, rather than the 35 percent required by Taiwan's graduated corporate income tax law.

To be eligible for this incentive, a trading company had to comply with the following:

a) have a predetermined annual income from exports according to the following schedule:

1983 - 20 million U.S. dollars,
1984 - 20 million U.S. dollars,
1985 - 50 million U.S. dollars,
1986 - 100 million U.S. dollars,
1987 - to be established;

b) maintain outstanding capital in excess of NT $200 million;

c) operate only an export-import business; and

d) maintain overseas subsidiaries in more than three countries.

In 1983, 2,785 cases were declared and the total amount of taxes foregone was approximately US $1,302,095.

The ITA argues that this particular provision of Article 15 is countervailable, because preferential tax treatment is based on export performance.

Article 15 also permits capital-intensive and/or technology-intensive enterprises engaged in the basic metal production industry, heavy machinery industry, or petrochemical industry to use a marginal tax rate of 22 percent, instead of the 35 percent rate required by Taiwan's income tax law.

In 1983, about 110 firms used this incentive. The total amount of taxation foregone was estimated to be about $US 76,254.

3. Duty Drawback[7]

Duty drawback is given on certain imported materials used to produce export products. Duty drawback is refunded on a shipment-by-shipment basis and is calculated by applying a pre-established duty drawback rate to the net weight of the finished product in each export shipment. The duty drawback rate is based on raw material usage and production yield data submitted by manufacturers of the export product.

The ITA determined that a duty drawback program that includes some amount of loss or wastage in the calculation of the amount to be remitted on raw materials used in the manufacture of exported goods is not necessarily countervailable when not unreasonable or excessive. When wastage rates or losses are excessive, the program is considered by the ITA to be countervailable.

4. Article 21[8]

Article 21 of SEI allows productive enterprises to pay import duties and dues on selected capital equipment in a series of installments, beginning one year from the date of importation. Qualified enterprises are also exempt from import duties on selected machinery and equipment used for the establishment or expansion of an approved project or for research and development.

5. Accelerated Depreciation and Tax Holiday[9]

Article 6 of SEI allows newly established "productive enterprises" either to use accelerated depreciation (at a rate twice as fast as is normally allowed) on fixed assets, machinery, and equipment or to select a five-year tax holiday. The company may defer the start of the tax holiday for up to four years. In addition, revenues arising from subsequent increase in productive capacity are tax-free for four years. Most Taiwan firms choose the five-year tax holiday. The statute makes one stipulation--it requires the purchase of domestically-made products. This condition has frequently been ignored simply because there has been a demand for sophisticated equipment that is not manufactured locally. The Taiwan authorities have found that these tax incentives have actually increased imports.

575 cases were declared for 1983. Of the total, 315 chose the tax-holiday and 211 selected exemptions during the four-year period of newly expanded enterprises. The total amount of taxes foregone due to Article 6 was approximately $US 2 million.

The ITA has no official position regarding this incentive.

6. Article 29[10]

Article 29 of SEI exempts export sales (which include sales to trading companies and to manufacturers for further processing before export) from the business tax. The amount of the exemption equals the amount of business tax due on each sale destined for export. Companies pay the business tax monthly and receive exemptions for export at that time. Such exemptions take the form of a rebate of taxes paid.

Firms involved with direct and indirect export activities, handling international transportation business, and foreign exchange dealers are all eligible for Article 29 tax benefits. Of all tax incentive programs, this was the most widely used one in 1983. 1.5 million cases were declared and approximately US$ 6.9 million were foregone in taxes.

The ITA determined that this program is not countervailable, because the non-excessive remission of indirect taxes levied at the final stage is not considered a subsidy.

7. Article 33[11]

Article 33 of SEI allows firms to reduce the stamp tax from 0.4 to 0.1 percent for transactions exempt from the business tax. The stamp tax reduction is less than the amount of stamp tax due on each sale destined for export.

In 1983, 1,496,756 cases were declared and approximately US$ 2.3 million were foregone in taxes.

Because the amount of the reduction is not greater than the amount of the stamp tax due, the ITA determined that this program does not confer a subsidy under U.S. law.

8. Article 42 and 43[12]

Article 42 and Article 43 allow firms to be exempted from paying taxes on the appreciated value of assets as a result of reevaluation as well as foreign currency debt.

In 1983, 214 cases were declared and approximately US$ 94,000 were foregone in taxes.

9. Firms in targeted industries often do not have to pay duties on imported inputs or can pay them on a deferred basis.

10. Entertainment Tax Deductions[13]

The allowable income tax deduction for entertainment expenses is increased for export firms. Generally, companies deduct 0.6 percent of the first NT $10 million of sales and 0.3 percent of the excess for entertainment expenses. Exporters are allowed to deduct an additional 2.0 percent of total export sales for entertainment expenses and an additional $100 per day, per employee, as a per diem travel expense.

11. Rebate on Commodity Tax[14]

A commodity tax, which ranges from 3 to 120 percent ad valorem, is levied on 19 types of commodities sold for consumption in Taiwan. The commodity tax is rebated if the goods are used in the manufacture of export items. To qualify for this rebate, the processed product must be exported within one year of the import. Commodity taxes are also waived if the goods will be used as raw material in the manufacture of another tradable commodity.

C. Other Instruments

1. Preferential Prices for Raw Materials[15]

The China Steel Corporation (CSC), a state-owned corporation and supplier of pipe and tube inputs, provides coil at preferential prices to exporters. Upon further investigation, the ITA determined that CSC does have a two-tier pricing policy, but all coil prices are set at or above the world market price. The ITA therefore determined that this program did not confer a subsidy.

II. DOMESTIC INCENTIVES

A. Financial Instruments

1. The Bank of Communications (BOC)[16]

The Bank of Communications (BOC) is Taiwan's most important bank carrying out industrial policy. It has been involved in infrastructure financing for seventy-six years and was officially designated a development bank in 1979. BOC is charged with the responsibility of extending concessional loans and credit guarantees to capital-intensive industries. It also directly invests in new high-technology firms and advises customers on how to improve management and increase technical innovation.

BOC is required to allocate 70 percent of its new loans each year for mid-term project finance. Loans can be obtained for the purchase of local Taiwan-made machinery, the purchase of automated machinery, and the manufacture of strategic products.

It had authorized capital of approximately US$ 256 million at the end of 1983, and total loans and loan guarantees outstanding were approximately US$ 2.2 billion, with more than 42 percent going to finance infrastructure-related activities. The manufacturing sector--chemicals, textiles, metals, transportation equipment, machinery and electronics industries together--accounted for slightly less than half of the BOC's new loans in 1983.

The BOC's interest rate is set 2 percentage points below the average of prevailing long-term rates, and the loans must be repaid over a 10-year period.

BOC development loans for the purchase of local Taiwan-made machinery are provided to a broad range of industries; the Department of Commerce therefore determined that development loans under BOC are not countervailable.

2. The Small- and Medium-Business Credit Guarantee Fund[17]

More than 50 percent of Taiwan's industrial output is produced by small and medium-sized businesses. The Small- and Medium-Business Credit Guarantee Fund was founded in 1974 to provide credit guarantees to financial institutions that lend to such firms.

The Fund extends eight kinds of credit guarantees, including those for general purpose loans, export financing, small-scale business loans, import letters of credit, import duty on account, bill of exchange acceptance, commercial paper, and performance bond guarantees. In addition, it makes special guarantees in accordance with government policy, including guarantees to provide relief to larger-scale export and machinery concerns.

The Fund has steadily grown during its nine-year existence. As of July 31, 1983, the guarantee balance reached approximately $461.5 million, and 30,000 firms had received guarantees.

3. The China Development Corporation (CDC)[18]

Although the China Development Corporation (CDC) is only partially funded by the authorities, this specialized banking institution takes government policy into account when extending loans and loan guarantees or making equity investments in firms. In line with current policy, the CDC now favors technology-intensive industries in its lending.

In 1982, the CDC approved about $23.8 million in loans to private firms, with the average loan totalling $525,000. Firms in the chemical industry accounted for 46.5 percent of the loans extended, followed by the food processing industry with 24.7 percent. The machinery and electronics industries received 11.5 and 7.0 percent, respectively.

CDC had direct investments worth $27.4 million in 1982, spread over 49 firms: 17 firms in the chemical industry, 12 in the electronics industry, five in the machinery industry, two in the food processing industry, and one in the metal-processing industry. The remaining 12 companies were in other industries. At year-end 1982, total guarantees outstanding were worth $18 million.

B. Fiscal Instruments

1. Article 10[19]

Under Article 10 of SEI, productive enterprises may deduct up to 15 percent of the value of capital equipment purchased during the year from the income tax liability. In the event that the amount of tax credit exceeds the value of income tax payable, the balance may be carried forward for up to four subsequent years.

Article 10 benefits are available to all productive enterprises and are therefore not considered to be countervailable under U.S. statute.

2. Business Tax[20]

To raise revenue, the government levies a business tax on gross business receipts (exports are exempted). There are four different rates that range from 0.6 percent for manufactured products to 4.0 percent for the banking and financial sectors. This tax incentive tends to favor growth of the manufacturing sector at the expense of the service sector.

3. To encourage the purchase of foreign technology by local firms, the government allows firms to deduct technology royalty payments from income liability. Similarly, income from licensing of technology, patents, and manufacturing processes is exempt from income tax.

4. To encourage listing on the stock exchange, the government allows firms to lower their income tax bill by 15 percent for each of the three years following public listing. Incorporated companies also qualify for an income tax rate of 25 percent, rather than the normal 35 percent.

5. Article 40 and Article 38

To encourage greater economies of scale in production, firms that have consolidated or merged with approval from the Ministry of Economic Affairs are exempt from paying capital gains taxes and can reduce their income tax bill by 15 percent for the following two years.

TAIWAN'S COUNTERVAILABLE SUBSIDY PROGRAMS UNDER U.S. LAW 1979-1986

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
Deferred Payment of Duties on Machinery	1979	Bicycle Tires and Tubes	0.002
Duty Drawback on Imported Materials Not Physically Incorporated in Export Merchandise	1986	Certain Stainless Steel Cooking Ware	0.535
Export Loss Reserve	1985	Welded Carbon Steel Pipe	0.2
	1986	Oil Country Tubular Goods	0.01
		Certain Stainless Steel Cooking Ware	0.535
Overrebate of Duty Drawback on Imported Materials Physically Incorporated in Export Merchandise	1986	Certain Stainless Steel Cooking Ware	0.535
Preferential Export Financing	1979	Bicycle Tires and Tubes	0.03
	1985	Welded Carbon Steel	0.002

PROGRAM	DETERMINATION'S EFFECTIVE DATE	U.S. COUNTERVAILING CASE	AD VALOREM DUTY
	1986	Oil Country Tubular Goods	0.10
		Porcelain-On-Steel Cooking Ware	0.1610
Preferential Income Tax Ceiling	1979	Bicycle Tires and Tubes	0.27
	1982	Fireplace Mesh	0.012
	1986	Porcelain-On-Steel Cooking Ware	0.1610
		Certain Stainless Steel Cooking Ware	0.535

Source: This table is based on the testimony and findings of the CVD cases filed in the Federal Register and U.S. Department of Commerce's subsidies library.

NOTES

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6. Ibid.

7. Ibid.

8. Ibid.

9. Ibid.

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11. Ibid.

12. United States International Trade Commission, Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan, USITC Publication 1632 (Washington, D.C.: USITC, January 1985), p. 250.

13. Ibid., p. 244.

14. Ibid.

15. Federal Register. Volume 51, No. 228, 26 November 1986, p. 42893.

16. Ibid., p. 259.

17. Ibid.

18. Ibid.

19. _Federal Register_, Volume 51, No. 104, 30 May 1986, p. 19586.

20. United States International Trade Commission, _Foreign Industrial Targeting and Its Effects on U.S. Industries Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan_, USITC Publication 1632 (Washington, D.C.: USITC, January 1985), p. 245.

ANNEX K

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